

THE GOLD PROBLEM

BY THE SAME AUTHOR

THE INDIAN TARIFF POLICY

With Special Reference to Sugar Protection

SANKHYA, THE INDIAN JOURNAL OF STATISTICS—

The book starts with a clear and acute theoretical analysis of the influence of protection on exports and imports. In a series of closely reasoned arguments it is shown that restriction of imports by its deflationary effects on other countries will under existing conditions inevitably lead to a decrease in exports, and that protection cannot in any case be considered as a cure for unemployment...Chapter IV gives a valuable study of the agricultural aspect of sugar protection. There is an admirable summing up in the last Chapter.

The book reveals a keen and scientific mind, an independent outlook and a sense of our own responsibility in improving the economic condition of India instead of looking up to the Government for magical results by state action.

The argument rests partly on certain basic theories of international trade and monetary policy, and partly on the evidence of concrete statistics. The use and interpretation of the statistical material in this book is excellent.

The book is definitely anti-protectionist in character and supports a view which is extremely unpopular in India at present. The arguments advanced appear to be formidable and cannot be ignored. Mr. Adarkar has written an important book and has thrown down a challenge which must be taken up by the protectionist school. The quality of printing and production is rare in this country.

Contd. on page facing 174

THE GOLD PROBLEM

A STUDY IN INTERNATIONAL FINANCE

BY

BHASKAR NAMDEO ADARKAR

M. A. (CANTAB.)

AUTHOR OF " THE INDIAN TARIFF POLICY "
AND " DEVALUATION OF THE RUPEE "

1937

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. PREFACE

SOME of the best brains in the world are at present engaged in solving the riddle of gold. This book does not pretend to have made their task less difficult than it is, and I will be satisfied if it is regarded simply as an introduction to certain important problems that have been raised by the international gold and capital movements in the last few years.

The subject has been treated purely from an international point of view. I have purposely refrained from commenting extensively on the question of the Indian gold exports, because it has been already discussed threadbare by many Indian economists and I have also had an occasion to deal with it in my booklet, *Devaluation of the Rupee*.

Coming to the very pleasant duty of thanksgiving, I must mention that this book had the rare fortune of receiving a kind perusal, in its manuscript form, from one who, by virtue of his learning and experience, is undoubtedly one of the highest authorities on British as well as international finance. I need only say that I feel as deeply indebted to him as to anybody else in the world.

I may also take this opportunity of thanking all who have assisted me in the preparation of this work. I would particularly mention my obligations to my cousin, Professor B. P. Adarkar of the Allahabad University and my friend, Professor D. Ghosh of the Bombay University, with whom I have had many valuable discussions on the subject. I am highly grateful to them as also to my learned friend, Khan Bahadur Dr. S. N. A. Jafri, for his kindly interest and assistance. None of these gentlemen, however, undertake any responsibility for the views expressed by me. I have also to thank Mr. A. S. Banavalikar, who has helped me by some clever suggestions towards improving the general presentation of the work.

Finally, I must add that I owe the very idea of writing a book on this subject to my brother, Mr. V. N. Adarkar, whose constant advice in such matters is one of my most valuable assets.

B. N. ADARKAR

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CHAPTER I

THE SUPPLY OF GOLD

FROM time immemorial the *auri sacra fames* has continued to make an appeal to the deepest instincts of man. Early in the dawn of history, nearly two thousand years before the beginning of the Christian era, when the sacred Hymns of the Vedas were composed, the poet sages of India sang some of their choicest hymns in praise of gold.¹ The gods of winds and waters were imagined as covered with golden ornaments, using golden weapons and showering their blessings on the earth in the form of gold.² The boon of immortality was promised to all who gave gold to the sacrificial priests.³ India is a land of gold and in spite of the caravans of treasure that he removed out of India in his sixteen successive raids, the notorious Muhammad Gazni

1. The Golden Age preceded the Iron Age. "The ancient men knew the use of gold long before they acquired a knowledge of copper or iron for the purpose of making tools." V. Smith : *Oxford History of India*, p. 3.

2. "हिरण्यरूपः स हिरण्यसंदृक् । अपां नपात्सेदु हिरण्यवर्णः ॥
हिरण्ययात्परि योनेर्निषद्या । हिरण्यदा ददत्यन्नमस्मै ॥ "

Rigveda ii. 35. 10.

Translation : The son of waters is of golden form, of golden aspect, of golden hue. To him coming from a golden womb, the givers of gold give food.

3. हिरण्यदा अमृतत्वं भजन्ते । *Rigveda* x. 107. 2. "The givers of gold attain immortality."

remained just a poor man as compared to the amount of gold he left behind. Vast quantities of precious metals must have poured into this land in the course of its trade with the Roman Empire and although gold went out of the country during certain periods, the movement was mostly inward since the fifteenth century when the country began its commercial relations with foreign countries on a large scale.

Although gold is worshipped with a peculiar fervour in India, it has also played its part in the life and history of several other nations in the ancient world. The exploration of America was in fact a search for the yellow metal and the flow of gold that came out of the New World during the sixteenth century gave countries like Spain one of their periods of exceptional prosperity. Thanks to the bravery of Sir Francis Drake, England too had a share in this flow of American gold. The history of gold is as bright and luminous as the metal itself.

It is not known where gold was first mined, but it seems that during the Middle Ages, Saxony, Austria and Spain were the important producers of gold. After the discovery of America, Mexico and Brazil became important sources of supply and they remained in that position for two centuries. In 1823, Russia became prominent and threw all other producers into the background. For a quarter of a century (from 1823 to 1848) Russia contributed nearly fifty per cent of the world's total supply. In 1849, however, the Californian mines were discovered

and in 1852, Australia became an important gold producer with the result that Russia ceased to be the leading gold producing country. Between 1853 and 1893 the United States and Australia vied with one another for the premier position, Russia lagging behind as the third. Nearly eighty-seven per cent of the world's supply was produced in these three countries during this period. In 1885, the Witwaterstrand (in South Africa) was discovered, and it began to make its full contribution to the world's supply of gold in 1898. Since that year to this date, it has remained the world's largest gold producer.¹ The

1 World Production of Gold by Periods. (a)
1493—1936

	Fine ozs.	£. m.	(b) Annual rate of increase in £. m.
1493-1600	24,266,820	103.1	0.9
1601-1700	29,330,445	124.6	1.2
1701-1800	61,088,215	259.5	2.6
1801-1850	38,093,570	161.8	3.2
1851-1900(c)	334,179,599	1,419.5	28.4
1901-1932	621,191,959	2,638.6	82.5
1933-1936	118,785,000	504.8	126.2
Total	1,226,935,608	5,211.9	

(a) Based on the Gold Number of *The Times*, p. 21.

(b) At the rate of 84s. 11½d. per fine oz.

(c) Note the revolutionary change after 1850

discoveries of the Californian and Australian mines in the fifties and of the Witwaterstrand in the nineties were important landmarks in the history of gold mining; because out of 1226.9 millions of fine ounces of gold that have been produced in the world since 1493 A.D., nearly 1074.1 millions have been produced since 1851 to date, and 739.9 millions since the beginning of the present century. Apart from the discovery of the Witwaterstrand, the introduction of the cyanide process for raising the recovery percentage was also a factor in the revolutionary increase in gold production since 1901.¹ At present the important gold producing countries of the world are South Africa, Russia, Canada and the United States of America. Between them they produce more than 76 per cent of the world's annual production.

The output of gold reached its maximum before 1932 in the year 1915, when it attained the level of 22.6 million ozs. or £ 96.6 m. It fell continuously from 1915 to 1922 due to the rise in the cost of production resulting from high commodity prices and frequent recurrence of labour troubles in South Africa. After 1922 it rose again. The rise in the annual production was accelerated particularly after 1931, when the price of gold in most of its important markets soared high due to currency depreciation. The following table² shows the world production of gold during the period 1923-36.

1. Sir Joseph Kitchin's paper on Gold Production in *The International Gold Problem*. (Royal Institute of International Affairs).
2. *The Seventh Annual Report of the Bank for International Settlements*.

THE SUPPLY OF GOLD

	South Africa.	U.S.A.	Canada.	U.S.S. R.	Other Coun- tries.	Total for the world	
Year.	In thousands of ounces of fine gold.						In milli ons of Swiss francs
1915	9,096	4,888	918	1,546	6,146	22,594	2,420
1923	9,149	2,503	1,233	438	4,463	17,786	1,905
1924	9,575	2,529	1,525	594	4,827	19,050	2,041
1925	9,598	2,412	1,736	693	4,592	19,031	2,039
1926	9,955	2,335	1,754	895	4,430	19,369	2,075
1927	10,122	2,197	1,853	810	4,464	19,446	2,083
1928	10,354	2,233	1,891	899	4,206	19,583	2,098
1929	10,412	2,208	1,928	1,085	4,040	19,673	2,108
1930	10,716	2,286	2,102	1,434	4,184	20,722	2,220
1931	10,878	2,396	2,694	1,701	4,702	22,371	2,397
1932	11,559	2,449	3,044	1,990	5,224	24,266	2,600
1933	11,014	2,537	2,949	2,667	6,347	25,514	2,733
1934	10,480	2,916	2,965	4,263	6,715	27,339	2,929
1935	10,773	3,619	3,280	5,650	7,356	30,678	3,287
1936	11,339	4,295	3,721	7,350	8,549	35,254	3,777

In 1850, the annual rate of output was only 3.5 million ounces, in 1929, it was 19.6 m. while today, it is 35.2 millions. The latest B. I. S. Report points out that the increase in gold production in the two years 1935 and 1936 is comparable with the increase previously registered at the time of the great discoveries of gold mines. Only a few years ago, the Gold Delegation of the Financial Committee of the League of Nations had declared that by 1934, the new gold available for monetary purposes would fall short of the amount required to maintain prices

at their 1928 level. Mr. Kitchin remarked before the Macmillan Committee in 1930¹ that within a decade, the world's annual output of gold would fall from £83 million to £76 million. The fall in prices since 1930 was attributed directly to this shortage of gold and it was held by many experts that unless drastic steps were taken to economise the use of gold, the inadequacy of gold might act as a drag on the price level for several years to come. All these apprehensions have been falsified by the event. While the Gold Delegation visualised a production of 78.4 million ozs. for the period 1931 to 1934 inclusive, the actual production during this period amounted to 99.5 million ozs. After 1931, the production in many countries was greatly stimulated by the rise in the price of gold in terms of national currencies. The South African pound, for example, was devalued in December 1932, as a result of which the paper price of gold in South Africa rose in 1933 and 1934. Due to the depression in other industries, the gold mining industry was able to secure an adequate supply of native labour at old wage rates and its profit margin continued unchanged with the increase in production. The same factors have been in operation in other gold producing countries also. Not a little of this progress is due to Government encouragement. The Canadian Government has lately tried to encourage geological research by

¹ *Report of the Committee on Finance and Industry*, p. 65. Also Keynes: *A Treatise on Money*, Vol. II, p. 296.

handsome subsidies. The number of gold mining enterprises in Canada has increased from 32 in 1931 to 155 in 1936.¹ The United States has also taken steps to encourage gold mining by giving federal loans.² The immediate outlook, therefore, is not one of shortage, but of a superabundance of gold.

Since 1929, the gold output of the rest of the world has increased much more than that of South Africa which contributed 32.1 per cent of the world output in 1936, as compared to 53.2 per cent in 1929.³ This change in the relative position of South Africa is due, firstly, to the developments in other gold producing countries, notably Russia, Canada and the United States and secondly, to the policy of the South African gold mining concerns to concentrate on low grade ores. In order to conserve higher grades, it was decided to work lower grades so long as profits were high, but this meant an extension of the milling plant which could not immediately make its full contribution to the current output. The Union Corporation estimates that by 1937 the increased capacity of the plant and bringing into production of new mines will more than offset the reduction in output due to the milling of low grade ore and the South

1. Charles O. Hardy : *Is there enough Gold?* p. 60.

2. Taskar L. Oddie on "Gold Production", in the *Mining Journal*, 1936.

3. Busschau : *The Theory of Gold Supply*, pp. 1-2 and p. 181.

African output may expand to the level of 15 million ounces within the next five or six years. The conservation of higher ores is certainly a wise policy, because it lengthens the life of the mines and also makes sure of a higher rate of annual output in the future.

There has recently been a tremendous increase in the output of Russian mines. While in 1913 the Russian output amounted to 1.7 million ounces only, it now amounts to 5.6 million ounces. While before the war the Russian output was only a fraction of the South African, it now amounts to more than half the latter. Considerable amounts of capital have been invested by the State in gold mining, and labour costs have been drastically reduced. According to the prediction made by the Chief of the Soviet Trust which is concerned with gold production,¹ the Russian mines would attain a rate of 11 million ounces by 1940. Within a short time Russia hopes to compete with South Africa as the world's premier gold producer, if the South African production fails to keep up its present rate of increase.

The Canadian output has also increased from 1,928,000 ounces in 1929 to 3,721,000 ounces in 1936. Apart from the decline in costs of production due to the general depression in trade and industry, the expansion of the Canadian output has been mainly attributed to the exploration of ore reserves in certain

1. Quoted by Keynes: "The Supply of Gold" in the *Economic Journal*, September, 1936.

inaccessible parts of Canada such as the Northern Ontario and is, therefore, of a permanent character. The increase in the gold production of the United States, however, from 2,208,000 ounces in 1929 to 4,295,000 ounces in 1936 is believed to have been caused mainly by the general depression in other industries and is, therefore, not expected to be permanent.

Thus, out of the four important sources of supply, at least three, namely, South Africa, Russia and Canada, show a promise of a substantial increase in output in the near future. If South Africa reaches the expected level of 15 million ounces, and Russia the level of 11 million ounces, by 1940, and in the meanwhile Canadian production also maintains its present rate of increase, the total annual output may easily amount to 40 to 43 million ounces in the next three or four years. This will be more than twice as much as the annual output in 1929. Considering the rise in the price of gold in terms of currencies like sterling or dollar, the increase in the money value of the annual output of gold would amount to nearly 275 per cent of its value in 1929.

It is not surprising, then, that this rising production of gold has begun to perplex the financial brains of the world. The problem is how to save the world's monetary systems from the dangers of a gold inflation and at the same time to prevent a fall in the price of gold. This flood of gold from the the mines is being swelled further by shipments of

dishoarded gold from the East. India and China which were traditional absorbers of gold have turned into huge exporters of the yellow metal, as the following table¹ will show:—

	Gold exports from			
	India	China	Hong Kong	Total
	(in millions of Swiss francs)			
1931	477	54	63	594
1932	1,014	118	59	1,191
1933	653	74	100	827
1934	706	54	68	828
1935	495	43	34	572
1936	371	37	29	437
	3,716	380	353	4,449

From September 1931 to March 1937 India has exported nearly 35.3 million ounces, which is almost equal to the world production for 1936. And a good deal still remains buried in the land. The net imports of gold into India from 1901-2 to 1930-31 amounted to 670 crores,² while our exports since September 1931 to date have totalled only 303 crores; which means that nearly 55 per cent of the gold imported since the beginning of the present century is still hidden in the country.³

1. *The Seventh Annual Report of the B.I.S.*

2 Estimated from the *Review of Trade of India, 1934-35*, p. 165.

3. The Indian absorption of gold is believed to have increased steadily after 1850. According to Mr. Kitchin's estimate, India imported nearly 16 per cent of the world's gold

The proportion of new gold that is available for monetary purposes has changed from time to time. It depends on two important factors; one is the needs of industrial consumption and the other is the demand for hoarding purposes. As regards the amount required for industrial consumption, there is no unanimity of opinion among the experts on the subject. Kitchin, Eddie and Loveday have produced three different estimates by following three different methods of calculation.¹ While Kitchin believed that only £ 15 million were required for consumption in the arts, Eddie thought £ 35 m. was the proper estimate and Loveday's calculations yielded £ 19.5 (or \$ 95 m.) as the correct figure.² These estimates were current in the year 1929. Lately Dr. Charles Hardy has produced a new estimate by applying Eddie's methods of calculation to the Gold Delegation's estimates of gold stock from 1913 to 1928. He says, "We suggest \$100 million (or £20.5 m. at par) as a reasonable

production between the years 1890 and 1931 and 25 per cent during the last decade of the period. During the same periods the rest of the world absorbed only 26 and 21 per cent respectively for non-monetary purposes. Cf. P. J. Thomas in the *Economist* of 19-6-37, p.686.

1. For a detailed discussion of the methods used by Kitchin, Eddie, Loveday, Warren and Pearson, see Charles Hardy: *Is there enough Gold?* p. 69.82.

2. Loveday's Memorandum to the Gold Delegation of the Financial Committee of the League of Nations: First Memorandum, 1930, p. 90.

round figure for probable industrial gold consumption over the next decade, with prices around 1929 level." ¹ This also appears to be an overestimate. Recently, there has been a considerable reduction in the demand for industrial consumption ². The Sixth Annual Report of the B. I. S. states that industrial consumption now does not exceed 5 per cent of the total production; which means that in 1936 not more than £ 7. 4 m. (at the rate of 85 s. per fine ounce or £ 12.25 m. at the present market price of £ 7 per fine ounce) was required for the purpose. The potential supply of gold for monetary purposes is, therefore, much bigger today than what it was in 1929.

Up to 1930, the demand for gold consisted mainly of industrial consumption, hoarding in the East and the monetary demand. As said above, the East has begun to dishoard gold since 1931, but a new factor has emerged in the form of private hoarding in the West. The B. I. S. Report estimated that at the end of 1934, the amount of gold privately hoarded in European countries amounted to 7,000 million Swiss francs or \$ 2273 m. at the new parity. Owing to the uncertainties about the future value of most currencies, gold became an attractive form of investment, the immediate loss of interest being

1. *Op. cit.* p.77.

2. Sir Henry Strakosch gave £ 6 m. (at the old mint price) as his estimate of industrial consumption in 1932. This worked out at 6.4 per cent of the production in that year. See *The Times*, Gold Number, pages 13—20.

outweighed in the minds of speculators by the expectation of a future appreciation. Recently, however, there has been a considerable reduction in the private hoarding of gold, which is now estimated at \$ 1000 m.¹ The following table shows the annual production of gold and changes in the central banks' gold reserves, the difference between the two being the amount required for industrial consumption and additions to private and public hoards. The public hoards consist of the unreported holdings of central banks and the different Exchange Equalisation Accounts.

In millions of fine ounces.

I	II	III	IV	V	VI
Year	Gold Production.	Dishoarding from India, China and Hong Kong.	Changes in gold reserves of Central Banks and Governments.	Additions to (+) or reduction in (—) amount of gold used for industrial and hoarding purposes.	Percentage of IV to the sum of II and III.
1931	22.4	5.5	+ 18	+ 9.9	64.2
1932	24.3	11.0	+ 29.3	+ 6.0	83.0
1933	25.5	7.7	+ 1.6	+ 31.6	6.0
1934	27.3	7.7	+ 45.1	— 10.1	128.5
1935	30.7	5.3	— 5.4	+ 41.4	— 14.0
1936	35.2	4.1	+ 30.8	+ 8.5	79.5
1931-6	165.4	41.3	+ 119.4	+ 87.3	58

1. This particular figure has been published by the Federal Reserve Board, *The Times of India*, 13-8-1937.

It will be noticed that from the beginning of 1931 to the end of 1936 the total gold production amounted to 165.4 million fine ounces and shipments from India, China and Hongkong to 41.3 million ounces. Out of the total supply of 206.7 m. ounces of gold that came on the world market only 119 m. or 58 per cent appears to have gone into central bank reserves between the two dates. Thus, roughly three-fifths of the newly available gold is allowed to find its way into monetary reserves, the rest being either consumed in arts, or held outside the monetary systems in Exchange Equalisation Accounts or privately hoarded.

It will also be clear from the above table that it was in two critical years, 1933 and 1935, that the private hoarding of gold was most pronounced. We will find an explanation of this fact in our analysis of the currency events since 1929 in the next Chapter.

The following table shows the distribution of gold in 1929 and 1936:—

Country.	1929 (December) (in millions of fine ounces)	1936 (December)
United States	188.6	322.0
England	34.3	73.8
France	79.0	85.5
Germany	26.3	0.8
Netherlands	8.7	14.0
Belgium	7.7	18.0
Switzerland	5.5	18.7
Total gold reserves of the world.	499.4 (50 countries)	647.5 (52 countries)
Percentage of the 7 countries mention- ed to the total.	69.7	82.2
Percentage of gold held by U. S., Eng- land and France to the total.	60.5	74.3
Percentage of gold held outside the three countries.	39.5	25.7

It will be observed that while the three countries United States, Great Britain and France held 60.5 per cent of the total gold reserves in 1929, they now hold 74.3 per cent. The percentage share of the U. S. has increased from 37.6 per cent to 49.7 per cent. Thus, the international movements of gold during the last seven years have done nothing to correct the

maldistribution of gold which was already an established fact in the year 1929. Germany which had \$ 544 m. worth of gold in 1929, now possesses only \$ 19 m. It is this maldistribution of gold that makes it extremely difficult to determine whether we have an excess of gold or a shortage of it. So long as countries like Germany which are dependent to a very large extent on the outside world for their raw material supplies, have little or no gold with which to purchase them, if necessary, it would sound sheer mockery to them to be told that the world is suffering from an excess of gold. Before, however, we take up the question of the future of gold, it will be interesting to take a bird's-eye view of the international gold movements during the entire period from 1929 to date so as to unravel the various factors that are responsible for the present distribution of gold. This we proceed to do in the next Chapter.

STATISTICS OF INTERNATIONAL GOLD MOVEMENTS

Net imports to and exports from (—)

	U.S.	Great Britain	France	Germany	Nether-lands	Switzer-land	British India
	(in thousands of dollars)						
• 1931							
3rd quarter	97,564	— 164,260	222,520	— 22,256	88,493	47,198	— 898
4th quarter	— 191,391	— 45,213	409,987	— 72,566	86,716	157,598	— 95,871
Total							
12 months	145,325	— 146,542	728,176	— 247,950	198,619	222,751	95,688
1932							
1st quarter	— 188,188	— 16,193	405,782	— 18,581	7,852	28,009	— 60,371
2nd quarter	— 431,800	78,140	246,074	— 12,325	120,100	129,461	— 33,974
3rd quarter	30,563	29,175	84,532	— 978	— 1,610	15,892	— 45,312
4th quarter	137,949	6,081	91,687	4,581	— 10,193	— 3,577	— 56,108
Total	— 451,476	97,203	828,075	— 27,303	116,149	169,785	— 195,765
1933							
1st quarter	124,160	52,338	— 22,329	— 21,815	— 8,355	— 11,280	— 37,426
2nd quarter	— 34,350	239,824	191,232	— 115,120	— 105,210	— 96,155	— 38,716
3rd quarter	— 221,003	162,944	147,545	23,036	27,099	— 14,188	— 30,680
4th quarter	— 42,543	212,482	— 72,353	11,044	18,956	31,622	— 19,053
Total	— 173,736	667,588	244,095	— 102,855	— 67,510	— 90,001	— 125,877
1934†							
1st quarter	685,223	381,521	— 420,779	— 57,803	— 126,596	— 53,369	— 83,925
2nd quarter	152,036	126,045	35,979	— 55,007	26,492	— 63,707	— 60,182
3rd quarter	70,901	80,484	— 17,036	9,857	6,107	47,711	— 28,229
4th quarter	223,835	126,799	— 5,125	12,033	— 28,666	23,300	— 58,386
Total	1,131,995	714,849	— 406,961	— 90,920	— 122,663	— 46,065	— 230,722

CHAPTER II

INTERNATIONAL GOLD MOVEMENTS 1929-37

I

GOLD ABSORPTION BY THE UNITED STATES AND FRANCE, 1929-32

THE scene of international finance in the years immediately preceding the onset of the World Depression was entirely dominated by the monetary policies of two great powers, the U. S. A. and France. The mutual similarities as well as the conflicts between the purely nationalistic policies of these countries convulsed the rest of the world by bringing about an irresistible drain of gold and a collapse of international prices. The present distribution of gold, which is certainly the most serious hindrance in the way of the restoration of a common monetary standard, is the direct result of their credit policies.

The United States of America has been absorbing gold throughout the post-war period. Even during the Great War, a considerable amount of gold flowed into the country between the years 1915 and 1917; but the really important influx of gold before 1930 took place in the period 1921-24 — the period of currency disorganisation in Europe. During these years, private lending from America to European countries fell off considerably, but the demand from them for American goods remained on

the old scale, with the result that America came to have an exceptionally favourable balance of payments which she realised in gold. By the middle of May 1927, the gold stock of the U. S. A. reached its maximum figure in the post-war decade of \$4700 millions, as compared with \$1812 millions in November 1914 when the Federal Reserve System was established. It was subsequently reduced in the last quarter of 1927 and the first half of 1928 as a result of the Reserve banks' policy of cheapening credit. The loss, however, was soon made good in a substantial measure in 1929, when a stock exchange boom attracted large quantities of foreign capital. Although the rise in the prices of securities which took place in 1929 was originally due to the cheap money policy of the Federal Reserve banks, the continuous inflow of foreign capital added fuel to the fire. Speculation went on increasing and there were growing demands for call money from the banks. The resulting rise in the call rate had just the perverse effect of further attracting foreign capital and thus giving a fresh impetus to the market.¹ Between January 11, and October 25, 1929, the gold stock of the United States increased by \$282 millions. The crash came in the autumn of 1929.

The depression of 1930 was largely due to the after-effects of this boom. By bringing about a great

1. *The Macmillan Report*, pp. 72-3.

Prof. L. Robbins: *The Great Depression*.

Keynes: *A Treatise on Money*, Vol. II, pp. 190-8, p. 326.

movement of gold and by causing American banks to liquidate their claims on other countries, it induced a state of acute monetary stringency in the rest of the world. The flow of international capital came to an end and the debtor countries and countries depending on primary production, which were already suffering from tariffs and the fall in prices, were left with no means to meet their external obligations other than by exporting gold. Germany, Australia, Argentina, Brazil and other debtor countries had to part with large amounts of gold. The American banking system was none too happy by this influx of the yellow metal. Those banks which were caught into the vortex of the boom were left with a large proportion of their assets in a frozen condition. During the two years 1930 and 1931, the bank failures in America reached a record number. Nearly 3000 banks were closed and deposits worth about \$ 2500 m. were irretrievably lost. This created a state of panic which was accentuated by the German default in July 1931 and the subsequent breakdown of the gold standard in England and elsewhere, and a wave of hoarding swept over the whole of the U. S. A. There was a great demand for notes, gold and silver for hoarding purposes. The growing scarcity of gold in the years 1929-31 had its origin not merely in the maldistribution of gold as between the reserves of central banks and governments but also in the great hoarding movement in countries like the U. S. A. and France during

that period. Had it not been for the release of distress gold from the debtor countries, this hoarding mania would have brought about the crisis much earlier than it did.

Before we proceed to describe the financial panics of 1931, we may turn our attention to France, the country which remained practically free from unemployment at a time when unemployment was increasing at an alarmingly rapid rate in England and America. During the years 1929-31, the American demand for gold was supplemented by the French demand. The stabilisation of the franc at a fraction of its former parity in 1928 introduced an era of great business activity in France. The expansion of production and employment which followed, resulted in an increase in the demand for currency. The shortage of currency was further accentuated by the abnormally high figures of the French Treasury balances. The note circulation increased from a yearly average of 53.5 milliard francs in 1927 to 73.8 milliards in the latter half of 1930.¹ There was also a continuous growth of bank deposits.

It was inevitable that this increase in deposits and note issue should be accompanied by an acquisition of an almost equivalent amount of gold. The entire monetary system of France is so shaped as to make any material expansion of credit impossible without additional gold. The cheque system is very

1. *The Macmillan Report*, p. 73.

inadequately developed in that country and cash is held mostly in the form of bank notes. The monetary legislation of 1928, moreover, intended to give the franc a purely metallic basis. The law of 7th August 1926, which allowed the Bank of France to buy foreign exchange was repealed in that year. Since the Bank was prohibited by its statutes to make unsecured advances, it could not even hold deposits with foreign banks. The result was that the Bank had no means whatsoever to prevent an influx of gold. Under the new law the Bank had no power even to buy government securities in the open market, and thus satisfy the demand for money by creating deposits. It had necessarily to acquire gold and to issue notes against it.¹

The absorption of gold in France from 1928 to 1931 was, thus, due entirely to an increase in the demand for currency. Gold worth about 16,603 million francs was drawn into the monetary reserves of France from September 1929 to May 1931.² The acute shortage of gold which was felt in 1931 was the direct outcome of this voracious absorption of gold by France and America during the two preceding years.

Both the countries continued to acquire gold in 1931; but while the import into the U. S. A. was checked in September 1931, France continued to

1. R. G. Hawtrey: *The Art of Central Banking*, Chapter I on the French Monetary Policy.

2. *Ibid*, pp. 32-5.

import gold up to June 1932. After the beginning of 1931, the major influence behind the flow of gold to France and the U. S. A. was the same, namely, a greatly increased demand for gold for hoarding purposes.

The year 1931 was a year of panic. The panic began with the collapse of the Credit Anstalt in Austria in May. This was soon followed in July by a wholesale withdrawal of balances from Germany. For some years, Germany had been satisfying its needs of working capital by obtaining acceptance credits through London and New York and by attracting time deposits from foreigners at handsome rates of interest. A large proportion of this short term debt was expressed in foreign currencies. Germany had already suffered two such withdrawals; one in March and April, 1929, during the Reparations discussions, when the French and Belgian balances were withdrawn, and the other in September, 1930, when the success of the extremists in the General Election created a feeling of distrust about the security of money in Germany. In July 1931 when the attack was renewed, the Reichsbank lost a milliard marks of gold and the banking system had to be closed. It was reopened after the conclusion of the Standstill Agreements with foreign creditors in August, 1931.

The story of England's departure from gold in September 1931 is too familiar to need repetition here. There were heavy gold losses in the latter

half of July, following upon the German crisis, because England was one of the principal creditors of Germany. The publication of the May Report with its recommendations for drastic economies, the arrangement of a credit of £ 130 m. from Paris and New York and the heavy budget deficit frightened the Continental creditors of London who began to withdraw their balances on a large scale. In the end, the gold standard had to be suspended on the 21st September 1931. The gold lost by England went to France and other Continental centres and America.

It will be observed that up to the crucial date of the 21st September 1931, a very complex set of forces was in operation behind the international movements of gold. The fall in prices and the reduction in the volume of international lending in 1930 was mainly responsible for the adverse balances of the debtor countries and the consequent loss of gold by them; while as regards the creditor countries like France and America, their capacity for absorbing gold increased considerably on account of internal hoarding of gold and notes and their unwillingness or inability (especially in the case of France) to allow the influx of gold to have its full effect on prices. While the Bank of France had no power to buy securities in the open market, the Federal Reserve banks did not resume their open market operations (which they had stopped in June 1930) till July 1931, by which time the hoarding

of notes and gold was increasing at a sufficiently rapid rate to nullify their effect.

From 1931 onwards, gold movements were dominated by movements of short term balances. America had a favourable balance on current account and France had an adverse balance in 1931. Still, as said above, while France continued to absorb gold after September 1931, America began to lose gold in that month. Like England, America was also one of the principal creditors of Germany. If the German default led to a wholesale withdrawal of balances from London and a partial default by the latter by way of currency depreciation, it was natural that New York also should have to face a similar ordeal. Soon after the suspension of the gold standard in England, gold began to flow out of America. The outflow came to an end in November 1931, by which time speculators were convinced of the inexhaustibility of the American monetary reserves.

In September and October 1931, the U. S. lost nearly \$ 703 million worth of gold. Her acquisitions from January 1930 to September 1931 had amounted to a similar figure; which means that the losses in the two months of September and October totally cancelled the gains made in the previous twenty months; and the gold stock of the country at the end of October 1931 was nearly at the same level as at the end of January 1930.

During the same period the gold stock of France was continuously increasing. The gold lost by the

United States went to France, Belgium, Switzerland and Holland. As Mr. Hawtrey says, if these four countries had allowed the inflow of gold to bring about a credit expansion and a rise in prices, they would have found it quite impossible to retain the gold. In France, the proceeds of the liquidation of short term balances (not only abroad but also at home) were allowed to accumulate in the form of enormous balances at the Central Bank or hoards of notes. "The cash in the four big commercial banks (including their deposits at the Bank of France) rose from the normal 3 milliards or so at which it stood in 1930 to 12 milliards at the end of 1931".¹

Taking the period from the beginning of 1930 to the middle of 1932 as a whole, it is clear that the flow of gold was prevailing in the direction of France, Holland, Switzerland and Belgium. Between September 1931 and June 1932, both the demand and supply of gold came to be influenced by new factors. On the side of demand, there was the rush by most of the Continental countries to reduce their short term balances held abroad or to convert them into gold and also the fact that new buyers like the Bank of England entered the market for gold. On the other hand, there were huge exports of gold from India and China, which increased the available supply, which was already being swelled by a rise in new production.

¹1. Hawtrey: *Op. cit.*, p. 226.

From September 1931 onwards the Continental countries were converting their foreign exchange holdings into gold. The Belgian National Bank liquidated all its holdings of foreign exchange and replaced them with gold: Switzerland and Holland also took similar measures but not so completely as Belgium. France increased her gold stock by 10 milliard francs between September and December 1931, but only 5 milliards of it represented a liquidation of foreign exchange. So far as France was concerned, it was in the first half of 1932 that the process really gained strength. Between 24th December 1931 and 8th July 1932 the foreign assets reserve of the Bank of France fell by 14.4 milliards and its gold reserve rose by 14 milliards.

The first three months of 1932 passed off comparatively quietly. The reorganisation of German banks in February, and the lowering of discount rates in England coupled with the strength of sterling appeared to create an atmosphere of confidence and some dishoarding took place. The Continental demand could be satisfied out of the dishoarded and newly-mined gold and there were no big withdrawals from the United States.

In February 1932, the U. S. Congress adopted the famous Glass Steagall Act by which the Federal Reserve banks were authorised to issue notes against U. S. Government securities. The adoption of this inflationary measure, together with the vigorous open market operations of the Federal Reserve

banks created apprehensions about the future of the dollar. The European Central Banks began to liquidate their dollar balances. The total volume of dollar balances converted into gold by the European Central Banks till the end of June 1932 amounted to \$700 millions. The demand for gold was further strengthened in the month of May when the Bank of England started buying gold and its gold reserve which was steady at £ 120.7 m. since November 1931 rose to £ 136.1 m. in June 1932. It increased further to £ 137.7 m. in July, to £ 138.9 m. in August and was steady at £ 139.4 m. in the next three months.

The Continental absorption of gold through the conversion of foreign exchange stopped in July 1932; and the withdrawals from the United States came to an end at the same time. The dollar was strong for the rest of the year. In the third quarter of the year, the atmosphere was fairly peaceful, due to the successful conversion in England of one-third of her public debt from 5 to 3½% and the hopeful outcome of the Lausanne Conference on the question of Reparations. A good deal of hoarded gold came on the market.

Towards the end of the year, however, the horizon again darkened. The war debt instalment which was due in December 1932 began to cause anxiety and the sterling-dollar exchange fell sharply. At the same time, a deficit began to appear in the French balance of payments. Since 1930, the

French Treasury had been financing its deficits by borrowing from commercial banks by means of treasury bills; it appeared certain that sooner or later a resort would have to be made to the Bank of France, with all its inflationary consequences. The investors were also agitated by fears of increased taxation. There was a flight from the franc and the dollar appreciated in terms of the franc as well as of sterling.

In short, during the first half of the year 1932, (and particularly in the second quarter), the flow of gold was towards England and the Continental countries, while in the second half, the direction was reversed. While the monetary stock of the United States fell sharply from \$ 4,416 m. in January to \$ 3,919 m. in June, it recovered rapidly by successive stages to \$ 4,513 m. in December 1932.

So far as sterling was concerned, the set-back of December 1932 was only a passing phase. The instalment of war debts, \$ 95,550,000 was paid in gold on December 15, after which sterling recovered. The first few months of 1933 were months of exceptional difficulty for the United States as well as France and other Continental countries, while England alone enjoyed the confidence of the world. Sterling was firm on the exchange and dollar depreciated rapidly.

II

THE AMERICAN GOLD POLICY, 1933-34

THE year 1933 saw the climax of all the financial difficulties from which the United States was suffering during the previous three years. The banks were already hit hard by the fall in agricultural prices and the reduction in land values had frozen most of their mortgage loans. The ill-advised publication of a list by the Reconstruction Finance Corporation of the institutions which had received its assistance revealed the true state of affairs and gave the signal for panic withdrawals from banks and an intensification of hoarding. State after State had to declare bank holidays. Finally, the President declared a bank holiday from March 6 to 13. There was an exodus of capital from New York and even the national capital sought refuge outside the country.

The United States had to part with a considerable amount of gold by the time an embargo was imposed on gold exports. The gold lost by the U.S. flowed into Great Britain. The Bank of England had already resumed its purchases of gold in the latter half of January and this influx of American capital served as a fortuitous aid in its task of replenishing its gold reserve which had fallen heavily in December 1932. The Bank's gold reserve increased from £. 123.6 m. in January to £. 185.9 m. in April 1933. In view of this continued growth, the Treasury's authorization of

August 1, 1931 to increase the fiduciary issue from £ 260 m. to £ 275 m. was allowed to expire on April 1, 1933.

On April 19, 1933, America officially left the gold standard. It was the first example in history of a country going off the gold standard with a stock of gold sufficient to cover 60 per cent of its demand liabilities. The balance of payments, too, was favourable; the foreign debtors were fairly regular in meeting the service of their loans and there was no real danger of the flight of American capital continuing for a long time. The departure from gold in the case of America was, thus, a matter of choice and not of compulsion.¹ The President was convinced, firstly, that a loss of gold, while making little difference to the apparently inexhaustible gold stock of America, may still be a serious hindrance in the way of a genuine restoration of confidence in the banking system, and secondly, that it was difficult to remedy the colossal fall in prices, which was really at the root of the banking trouble, without the application of some powerful psychological impetus like currency depreciation. It may be added, incidentally, that contrary to what one would expect, the suspension of the gold standard in the U.S.A. had a buoyant effect

1. Cf. "The abandonment of gold by the U. S. A. represents an arbitrary act of statesmanship which may, indeed, be justified on political or psychological grounds, but which was certainly not inevitable on technical or economic grounds"

T. E. Gregory: *The Gold Standard and its Future*, p. 103.

on the world market for commodities; the reason being that, surprisingly enough, the rise in American prices proceeded more rapidly than the fall in exchange. The flight of domestic capital which usually precipitates the fall in exchange under such circumstances was absent in the U. S. A. where people would rather cover the risk of currency depreciation by investing their money in goods or gold than in foreign currencies.

With the defection of America from their ranks, the real difficulties of the remaining gold standard countries began. Soon after the official suspension of the gold standard in the U. S. the exchanges of France, Holland and Switzerland came under a severe speculative pressure. Both Holland and Switzerland had to export gold to Paris which was simultaneously losing gold to London due to the appreciation of sterling. These countries had a sufficient stock of gold to meet any emergency. Switzerland had a gold reserve in 1933 which was well in excess of one hundred per cent of its note issue; and the position of Holland and France was not materially different. Nevertheless, it must be remembered that these countries were vast repositories of foreign funds, a sudden withdrawal of which was bound to upset the delicate balance of their banking system. Holland's position was peculiarly weak in this respect, because the foreign balances in Amsterdam were drawn mostly from one country, namely, Germany. These funds began to be transferred to London during the crisis of

February and caused an outflow of gold to London where the Bank of England was actively purchasing it since the middle of January. There was a keen demand for gold for hoarding purposes. As the Central Banks in Holland and Switzerland were under no legal obligation to pay gold for hoarding, the hoarders transferred their funds to France where they could be exchanged for gold. There was a pronounced increase in the hoarding of gold during the second quarter of 1933 all over the world. It has been estimated that a quarter of a billion dollars worth of gold passed into hoards or unreported holdings during the spring of 1933.¹

In the midst of these critical developments, France alone was able to obtain a temporary respite. Ever since December of the previous year, France was losing gold. Apart from the budgetary deficit, France had also to tackle the problems of an increase in domestic hoarding and an adverse balance which was mainly due to a decline in tourist expenditure and the moratorium and transfer restrictions to which certain international debts were subjected since 1931. The American crisis, however, served for a time to divert the speculators' attention from these difficulties. Besides, the British Exchange Equalisation Account came to the aid of France by actively supporting the franc. Towards the end of April a credit of £ 30 m. was arranged in London on behalf of France, and the depreciation of the franc in terms

1. See Table on page 13 and Cf. page 14 *supra*.

of sterling was thus effectively checked. It has been remarked¹ that the depreciation of the dollar was interpreted in London as a counterblast to the depreciation of the pound and served as an occasion for a financial *entente cordiale* between London and Paris.

During the deliberations of the World Economic Conference which was held in London in June 1933, the strain on the gold standard countries further increased. It appeared for a time that the future currency policy of these countries depended mainly on the outcome of the Conference on the question of stabilisation. The Conference failed to reach an agreement on the issue, due mainly to the firm stand taken by the President of the United States against stabilisation. In his message to the Conference on July 3, the President refused to support the Joint Declaration, issued by the Treasuries and Central Banks represented at the Conference, which called for the ultimate restoration of the gold standard and the maintenance of the *status quo* in the gold standard countries. He announced, "The U. S. seeks the kind of dollar which a generation hence will have the same purchasing and debt-paying power as the dollar value we hope to attain in the near future". This fiasco of the stabilisation proposal involved the European gold standard countries in a heavy loss of gold. In the course of a few months, the Swiss

1. Cf. Dr. Einzig: *The Sterling-Dollar-Franc Tangle*, Chapter III.

Bank lost gold worth 759 m., the Dutch Bank 400 m. and the Bank of France 500 m., Swiss francs.

The outflow of gold from the gold standard countries came to an end soon after the formation of what was afterwards known as the "gold bloc". On July 8, 1933 the Governors of the National Bank of Belgium, the Bank of Italy, the Netherlands Bank, the Bank of Poland and the National Bank of Switzerland met under the auspices of the Bank of France and agreed upon a common programme of defending the gold standard. This immediately resulted in relieving the pressure on the florin and the Swiss franc. The French franc enjoyed the confidence of speculators from July to September 1933 mainly because the pound was declining during this period. The Central Banks in the gold standard countries substantially increased their reserves during the third quarter of the year.

Apart from the currency uncertainties of 1933 and the consequent increase in hoarding, the demand for gold was further sustained by the continued conversion of foreign balances into gold by the European Central Banks. As has been already mentioned, the process started in the last quarter of 1931. It gained momentum during the first six months of 1932 when France reduced its foreign exchange holdings by 14 milliards. It is said that the liquidation of dollar balances by France in 1933 precipitated the American crisis. In 1928, France held an abnormally large proportion of its currency reserves in the

form of foreign exchange. On December 14, 1928, the foreign exchange holdings of the Bank of France amounted to 33,228 million francs; on the 18th September 1931, just before the process of liquidation was expedited, they stood at 25,121 millions. Between that date and the 24th June 1932 when the process slowed down, they were reduced by successive stages to only 6,000 millions and on the 17th November 1933, they stood at 1,279 million francs only. The decrease was largely due to purchase of gold abroad by the Bank in 1931 and 1932; although it must be remembered that the Bank has also written off losses caused by the depreciation of the currencies in which these balances were held. During 1933, the Bank had to provide 2,900 m. francs worth of foreign exchange to the French Government to enable it to repay the credit of £ 30 millions which it owed to London. During the same period, the Netherlands Bank also was following the French example of converting foreign exchange into gold. In the Annual Report of the Netherlands Bank for 1932-33 it has been stated that "the large gold stock of the Netherlands Bank is largely the result of the conversion of interest-bearing foreign investments and balances into non-interest-bearing gold."

According to the figures quoted in the Annual Report of the Bank of France for 1933, from January 1, 1931 to November 30, 1933, the volume of foreign exchange held by the European banks of issue

declined from 48, 464, 405,000 francs to 3,921,500,000 francs, or a reduction of more than 90 per cent. In 1931 the foreign exchange reserves held by Central Banks represented 32 per cent of their aggregate reserves; in 1933, they did not represent more than 2.5 per cent.

The gold purchases of the Bank of England, the increase in hoarding in the second quarter of 1933 and the conversion of foreign exchange into gold by the European Central Banks were the three major factors that intensified the demand for gold during 1933. The anti-hoarding measures taken in America during the banking crisis to some extent modified their effect. On March 8, the Federal Reserve Board requested the Reserve banks to prepare lists of persons who had recently withdrawn gold and did not redeposit it in a bank by March 13. On April 5, the President issued an executive decree forbidding the hoarding of gold. Persons holding gold which was not required for legitimate trade purposes were required to deliver it to the Treasury before May 1, 1933. These measures were completely effective, inasmuch as by the beginning of May most of the gold which was hoarded during the banking crisis was returned to the banking system.

In October 1933, the gold situation was further complicated by the emergence of a new factor in the form of the gold buying policy of the United States. On October 22, President Roosevelt announced his intention of obtaining a rise in American commodity

prices through the establishment of a Government market for gold in the United States.¹ The Reconstruction Finance Corporation was authorised to buy and sell gold on the world market at the current price, while on the American market it was to buy gold at a price to be determined after consultation with the President and the Secretary of the Treasury. The main object behind this policy was to bring about a further depreciation of the dollar by gradual increases in the price of gold. The opening price was fixed at 31.36 dollars per fine ounce; it was gradually raised by successive increases till on the 16th January, 1934 it stood at 34.45 dollars per fine ounce. As compared with the old mint price of 20.67 dollars per fine ounce, the price of 34.45 dollars represented a depreciation of 64.8 per cent. The depreciation of the dollar, however, between October to January did not fulfil the President's expectation of a substantial rise in the price level.² In fact, the experiment was not given a full trial, inasmuch as there was no revaluation of the gold reserve and no addition to the volume of purchasing power corresponding to the changing value of gold in terms of the dollar.³

1. In the inauguration of his gold buying policy the President was mainly influenced by the views of Messrs. Warren and Pearson.

2. Dr. Hardy : *Op. cit.* Section on "Gold and Prices."

3. T. E. Gregory : *The Gold Standard and its Future*. (The case of the U.S.A.) Of all prices, agricultural prices showed the closest correspondence with the trend of exchanges. But the

The amounts actually bought by the Reconstruction Finance Corporation¹ up to the end of 1933 were too small to be of any consequence, but the fact that the true purpose and significance of the policy was only inadequately understood in the outside world introduced an element of grave uncertainty in the international gold situation. So far from inducing a dishoarding of gold in response to the rise in price, it actually encouraged hoarding.

The gold buying policy of the U.S.A., moreover, was inaugurated at a time when there were already three or four other factors in operation to disturb the economic situation. The political atmosphere in Europe had become intensely grave due to the withdrawal of Germany on October 14, 1933 from the Disarmament Conference and the League of Nations. Sterling, which had enjoyed the confidence of Europe for the major portion of the year, was showing signs of weakness owing to seasonal tendencies. France was losing gold since September on account of a sudden outflow of capital. The budgetary problem in France was proving intractable and a succession

correspondence was closest in the earlier period, between March and October (i.e. before the gold experiment began) and after the end of the year (i.e. after the experiment was over). Certain basic commodities like pig iron, milk, coal, lumber etc., which do not have an international market failed to reflect the exchange movement.

1. The operations of the R. F. C. were confined to domestic purchases of gold from October 25 to 29, after which they were extended to foreign markets.

of Governments fell on the issue in a short period. It appeared that the French financial experts were at their wit's end in their attempts to remove the budgetary deficit and thus arrest the alarming growth of floating debt. From September to the middle of December 1933, France lost gold worth about 5,300 million francs; during the preceding nine months the loss of gold had amounted to 1,100 million francs only. By the middle of December at last, Parliament passed a law providing for the restoration of a balanced budget, and the withdrawals then ceased completely. In such a complicated international situation in which all the major economic powers were involved, it was not to be expected that large transfers of gold would take place from one centre to another. What actually happened was that there was an intensification of hoarding and large amounts of gold were drawn into unreported reserves. In the last two months of 1933, the demand for hoarding absorbed the whole of the current new production, gold exported from India and China and, in addition, gold worth about 670 million Swiss francs that was withdrawn from central bank reserves during the period.¹ The monetary systems of the world were subjected to an unprecedented strain in these two or three months.

In January 1934, the stage was reached for a revision of the American monetary policy. In view

1. See Table on p. 13 and cf. p. 14 *supra*. Cf. *The Fourth Annual Report of the Bank for International Settlements*.

of the failure of American prices to rise substantially during the preceding three months, it was thought that a mere depreciation of currency was not enough. It was considered necessary to mobilise the gold reserves of the country so as to expand the volume of purchasing power. Accordingly, the Gold Reserve Act of 1934 was passed. By this Act, the entire gold stock of the country including the vast holdings of the Federal Reserve banks was concentrated in the hands of the Treasury. The coinage of gold was discontinued and the existing supply of gold currency was ordered to be melted down. The redemption of currency in gold was abolished except under special currency regulations. The Act did not lay down any definite gold value for the dollar. It simply authorised the President to fix the value of the dollar between 50 and 60 per cent of its former gold parity.

If, however, the increased gold stock of the U. S. was really to be used for expanding the purchasing power, a definite gold value had to be fixed for the dollar, at which it could be revalued. The President, therefore, issued a Proclamation on the 31st January 1934 fixing the *de facto* weight of the dollar at $15\frac{5}{16}$ grains as compared to the old weight of 25.8 grains (a depreciation of 59.06 per cent) and the price of gold at \$ 35 per fine ounce as compared to the old price of \$ 20.67. The Treasury was to purchase all gold offered at this price. Although the price of gold in the U. S. has remained fixed at \$ 35 per fine ounce to this date, the President has reserved to himself the

right to modify the terms of the Proclamation as the interests of the United States may require. The gold stock of the country was revalued at this rate, as a result of which it increased by \$ 2,808 millions.

The stabilisation of the dollar was immediately followed by a great influx of gold to the United States. Gold worth about \$ 690 millions was imported into the country during February and March, the import during the one month of February amounting to \$453 millions. In the same month, the principal European central bank reserves were reduced by \$366 millions. For the year 1934 as a whole, the imports of gold in the U. S. aggregated more than a billion dollars! In commenting upon these sensational gold imports, Federal Reserve Bulletin¹ remarked, "The international gold movement in February was the largest in volume since September 1931 when financial disturbances in Europe led to heavy withdrawals from a number of countries."

The extraordinary gold movements of February, 1934 were caused mainly by the discrepancy between the gold value of the dollar and its value in terms of gold currencies. On the basis of the new parity of the dollar, the franc-dollar exchange ought to have been quoted at 6.63 cents to a franc. But actually the franc was quoted in February at 6.26 cents. It was, therefore, profitable to convert dollars into francs, to convert francs into gold, to ship gold to the United States and sell it to the Treasury at

1. March 1934, p. 144.

the rate of \$ 35. An additional cause of the gold movements is to be found in the fact that the U. S. A. had a substantial favourable balance of trade in February. The extraordinary magnitude of gold movements in that month was due to the combined operation of these two factors.

During 1934, the Treasury purchased \$ 1,100 m. of gold and \$ 200 m. of silver. Had it not been for the purchase of silver, the import of gold would have been bigger still.

As the gold movements proceeded, the discrepancy in the exchange rate was gradually corrected and the dollar depreciated to the appropriate level of 6.63 cents to a franc in March 1933. The surplus on the international balance of payments also gradually dwindled in that month. The flow of gold to the U. S., however, continued even in March. The distrust of European currencies was causing a periodic flight of capital from them and at the same time the security market in New York was attracting foreign investment capital.

By a curious coincidence, the stabilisation of the dollar synchronised with the financial difficulties of France. For some time, the Bank of France was losing gold as a result of a substantial adverse balance of trade combined with the cessation of Reparation payments, and diminished receipts from tourist traffic and foreign investments. The situation was further aggravated by a budgetary crisis in February. The outflow of gold, however, came to an end by the

beginning of March, partly because, as said above, the discrepancy in the Paris-New York rate was corrected, but mainly because of a change in administration. The French reserves showed an appreciable increase after the middle of April when the Government introduced new measures to balance the budget. Gold began to return to France and the return movement continued till November. There was an almost continuous repatriation of capital and even an import of foreign capital from March to November. During these nine months, the French currency reserves increased by 9,000 million francs. On December 14, 1934, the reserve percentage was 80.97, the highest since the law of 1928 became effective. In spite of this addition to reserves, neither the Treasury nor the banking system of France was really able to regain the confidence of the public.

Unlike France, both Switzerland and Holland continued to export gold in March and April 1934. They stopped in May. Over the year as a whole, gold reserves declined in the aggregate by \$137 millions in Belgium, Netherlands and Switzerland, by \$115 m. in Italy and by \$124 m. in Germany. France was the only European country in 1934 to increase its gold stock. London was also subject to an outflow of funds due to the repatriation of capital by the Americans who had transferred it there during the crisis of 1933.

III

THE DISRUPTION OF THE GOLD BLOC 1935-36

EVER since the year 1932, London has been increasing its stock of gold year by year. The net inward movement of gold amounted to 297 million Swiss francs in 1932, to 3,347 m. in 1933 and to 2,089 m. in 1934. Over the period of 1932-34 as a whole, the stock of gold in London increased by 5,733 m. Swiss francs. Of this only 1,800 m. was added to the reserves of the Bank of England.¹ The rest was either held in the Exchange Equalisation Account or in private hoards in London. According to the Fourth Annual Report of the Bank for International Settlements, the major portion of the gold imported during the period represented gold held in London on private account. A large number of Continental and other holders of gold had been transferring their hoards to London, in the belief that the British authorities were unlikely to interfere with the gold holdings of foreigners, as such a step would be prejudicial to the maintenance of a free gold market. It has been estimated that at the end of 1934 gold worth about 7,000 million Swiss francs was privately hoarded; since nearly 3,933 m. was added to the unreported hoardings in London between

1. These figures are deliberately expressed in Swiss francs; because the price of gold was steady in terms of this currency throughout this period, while it changed considerably in terms of sterling.

1932 and 1934, one can safely surmise that of the total amount of gold that was believed to be privately hoarded in the entire world in 1934, more than fifty per cent was concealed in the vaults of London.

It seems that in the latter half of 1934 and the beginning of 1935, the movement of gold to London represented mainly a transfer of hoards belonging to foreigners rather than a transfer of funds. It could not be otherwise, because sterling had a declining tendency during this period. After the stabilisation of the dollar, the Americans began to repatriate their capital which they had shifted to London during the spring of 1933 and mainly on account of this repatriation, there was a deficit in the net movement of funds and the Exchange Equalisation Account had to support sterling by selling gold. In January and February 1935, gold was actually moving out of England. Finally, in March 1935 when the pressure on sterling increased, the Exchange Equalisation Account allowed it to depreciate to 4.71. In January, Switzerland, Netherlands and Belgium were also losing gold to the United States.

Towards the end of February 1935, the pressure on the gold bloc eased and in March, the gold currencies were quoted above par. Towards the end of March, however, the belga fell and there was a sudden change in the international situation. From this point begins the disintegration of the gold bloc—a gradual loosening of ties between currencies that

were sworn to friendship since July 8, 1933,—which, in a way, was long overdue. The belga was the weakest link in the chain. Belgium had a comparatively small reserve and she was faced with a situation of the most perplexing kind. Her foreign trade on which her industry was mainly dependent, was shrinking in volume and its prospects were further complicated by the growing depreciation of sterling and foreign restrictive measures such as the British import duty on steel (imposed in March 1935). In Belgium, industries and banks are closely associated; as the industrial situation worsened, the banks found an increasing proportion of their assets in a frozen condition. The crisis came at the end of March, when, being unable to cope with the situation, the Government resigned. Under the new regime, the belga was devaluated by 28 per cent.

The devaluation of the belga had serious repercussions on the position of Netherlands, Switzerland and France. Their currencies were subjected to speculative raids one after another from April to June, 1935. The Dutch guilder was the first currency to be attacked. The technical position was fairly strong in all the three countries. They had ample gold reserves, and in the case of Netherlands, in addition to the reserves of the Central Bank, there were substantial gold holdings in the hands of corporations and private persons.¹ Even

1. *The Annual Report of the Netherlands Bank for 1933-34.*

the budgetary deficit in Netherlands was not excessive. Still, the fall of the belga created apprehensions about the safety of the guilder and there was a flight of capital, both national and foreign. The transfer of funds was encouraged by the wide discount on the forward guilder. The bank raised the discount rate from $2\frac{1}{2}$ to $4\frac{1}{2}$ per cent and the pressure on the guilder gradually eased. Almost simultaneously foreigners began to withdraw funds from Switzerland. Only the nationals of the countries which had prohibited their citizens to hold funds abroad could not take part in these withdrawals for fear of detection. The apprehensions about the future of the Swiss franc were further strengthened when it was proposed to hold a Referendum to decide whether Government should be authorised to carry out wholesale reflation by means of public works and social expenditure. Fortunately, the Referendum of June 2, 1935 decided otherwise and the fears about the Swiss currency were temporarily set at rest. The gold stock of the Swiss National Bank was reduced from 1,910 m. francs at the end of 1934 to 1,193 million francs by May 1935. The gold lost by Switzerland and Holland went to the United States, England, and also Belgium which became an importer of gold after devaluation.¹

1. In every case (except that of France) devaluation was followed by an inflow of gold (e. g. England, U. S. A., Belgium, Holland and Switzerland).

The withdrawals from Switzerland, however, continued even after the Referendum of June 2, 1935. The assets of the Swiss banks consisted mainly of credits granted to Germany, while their liabilities were in the form of balances due to foreigners or medium-term debentures which were automatically repayable on maturity. Under the peculiar transfer restrictions adopted by Germany, it involved a great loss to realise the credits granted to that country.¹ The Swiss banks, however, had substantial cash reserves out of which they met the withdrawals. The pressure ended in December 1935 by which time most of the foreign balances were withdrawn.

The outflow of gold from France in May and June, 1935 was caused as much by internal troubles, especially the budgetary crisis, as by the indirect repercussions of the currency difficulties in Belgium, Holland and Switzerland. On account of the colossal and recurring deficits in the budgets, the French Government was almost at the mercy of the Bank of France. M. Flandin had his notions about removing the budgetary deficit by a bold policy of reflation, but when the Bank of France refused to co-operate with him even to the extent of rediscounting Treasury bills without limit, he had to stoop to the dictates of the Bank and approach Parliament for special powers to take all kinds of deflationary steps. During the Parliamentary debate on this question, the

1. Dr. Einzig: *World Finance*, 1935-37.

Bank of France lost a considerable amount of gold.¹ M. Flandin was defeated, and his successor, M. Bouisson who stepped in, also met with the same fate. The panic about the French currency situation grew worse and the resulting loss of gold continued, till M. Laval assumed the Premiership in June and Parliament decided to give him the necessary powers to deal with the financial situation. The outflow of gold was then checked. On July 16, M. Laval inaugurated his programme of consistent deflation by issuing executive decrees whereby wages, rents, the prices of essential foodstuffs and raw materials, interest on Government bonds and other fixed charges were ordered to be reduced uniformly by ten per cent. For a month or two the decrees worked satisfactorily, inasmuch as they served to restore confidence in the French currency. There was also a moderate repatriation of capital.

Inspired by the French example, the Dutch Premier, Dr. Colijn, tried to carry out consistent deflation in July, 1935 in order to restore the budgetary balance and to complete the readjustment of the Netherlands economy to the international situation. He failed in his attempt and had to resign. The guilder was exposed to a selling pressure and the Central Bank lost gold heavily. A similar attempt to enforce deflationary decrees was made in September. The resistance offered to these decrees

1. In the month of May, 1935 the Bank of France lost gold worth 10 milliard francs.

brought about a major financial crisis. The decrees were finally accepted in a modified form, and the tension was relieved.

As said above, M. Laval's decrees worked satisfactorily only for a month or two. The so-called "consistent deflation" was not consistent enough. In the face of constant withdrawals of deposits, the Bank of France had necessarily to be accomodating to its member banks to protect the solvency of the banking system and had also to take Treasury bills to finance the current budgetary deficit which the Bank's own policy of consistent deflation could not remove. Thus, the very execution of deflationary measures led inevitably to a moderate measure of inflation.

The budgetary situation in France came to a head in November 1935, when the Finance Commission of the Chamber of Deputies refused to ratify M. Laval's decrees and the budget for 1936. The Bank of France lost gold heavily in November and December. Being unable to evolve a satisfactory plan to balance the budget, Laval's cabinet resigned in December and an interim cabinet was formed, after which the loss of gold diminished.

From September to December 1935, there were large-scale transfers of gold from Europe to America. As already mentioned, the economic decrees of Netherlands caused an outflow in September and the French budgetary crisis was responsible for the gold movements in November

and December. Between these two events came the outbreak of the Abyssinian war which increased the political tension in Europe. There were heavy transfers of funds from London to New York in September and October. The year 1935 was thus a year of a colossal gold movement to the United States. It took place in two parts,—once in April to June after the Belgian devaluation, and again in September to December.¹ Both England and Belgium also considerably increased their gold stocks during the year. It may be added that apart from the influx of short-term funds which were mainly influenced by financial crises, there was also an increase in the net long-term investment in American securities during 1935. The flow of gold to America in the year 1935 was mainly determined by this inward movement of capital and not by her transactions in goods and services which showed an adverse balance in 1935.²

Of all Continental countries the largest outflow of gold has taken place from France; the reason³ is that many countries deal in gold through the Bank of France which is the only Central Bank in the world that pays out gold for every purpose. Hence, much of Italian, Swiss and English gold has gone to America through France.

1. See Table on pp. 17-18.

2. See Appendix I. A more consistent account of international movements of capital during the period 1935-7 will be found in the next Chapter.

3. *Federal Reserve Bulletin*, December, 1935.

The movement of short-term funds to the United States was temporarily checked in the beginning of the year 1936. In February, there was actually an outflow of gold, while in March, the inflow was reduced to a small figure. For one thing, the war scare raised by the Abyssinian conflict (which was responsible for a transfer of funds from London to New York in September and October 1935) had now disappeared and the uncertainty caused by the French financial situation was also being gradually cleared up. The European balances held in New York were, therefore, reduced in the first few months of 1936. Besides, the people abroad had begun to feel highly apprehensive about the trend of American policy, in view of the extension (in January) of the President's power to devalue the dollar up to 50 per cent of its former parity. The payment of the adjusted service compensation and the decision of the Supreme Court invalidating certain taxes created uncertainty about the budgetary situation. As a combined result of these factors, the dollar showed a tendency towards weakness from January to the end of March.

The year 1936 was a fateful year for France. Month by month France was sinking deeper and deeper into the economic morass, and in face of the growing burden of debts and deficits, and a more or less sustained withdrawal of bank deposits, both the Government and the banking system were confronted with a grave menace. There was a considerable

increase in hoarding in the form of both gold and notes. In February, M. Sarraut arranged a credit of £ 40 m. with London banks on condition that the Bank of France would keep with the Bank of England an equivalent amount of sterling or gold. Since the gold pledged with the Bank of England was treated as part of the French reserve, this arrangement served the purpose of supporting the franc without bringing about an immediate loss of gold. On March 7, the Germans occupied the Rhineland, and immediately there was a rush of funds out of France. The French Government was unable to take any action, being obsessed with its own financial troubles. The entire amount of the credit arranged with London had to be sacrificed in an effort to save the franc. Then came the electoral campaign of April. The general expectation that the Socialists might succeed at the election hastened the export of capital. The expectation came true and the Popular Front parties, including the Radical Socialists, Socialists and Communists, were returned with a majority. Their election was followed by a renewed flight of capital and an outbreak of stay-in-strikes.

Between the beginning of January and the end of May 1936, the Bank of France lost nearly 10 milliards of gold, in addition to the 3 milliards of the London credit. For the reasons given above, the gold exported by France up to the end of March went only to Great Britain and not to America. The new Premier, M. Blum, proved himself to be

as incapable of mastering the situation as his predecessors. He initiated a series of Socialist measures, such as the 40-hour week, paid holidays etc., which, besides frightening capital and encouraging workers to persist in their game of stay-in-strikes, aggravated the disequilibrium between the costs of production in France and elsewhere. By embarking on a public works programme, he managed to increase the budgetary deficit instead of trying to decrease it. "If we assume that in May 1936, the franc was overvalued against sterling to the extent of 25 per cent, after the Socialist legislation the extent was 50 per cent." ¹

In July and August 1936, the export of gold from France was greatly reduced mainly because of the emphatic denial by the French Government of any intention to devalue the franc, and the cessation of the stay-in-strikes. In September, the fears about devaluation were again revived by rumours about currency negotiations between France, America and Great Britain. The gold reserve of the Bank of France began to drop at an alarming rate and the French Government was left with no alternative to devaluation. Consequently, the Government imposed an embargo on gold on September 26, and the franc was off gold. By the monetary law of October 1, 1936, the gold content of the franc was fixed between 43 and 49 milligrammes as compared with the old

1. Einzig : *World Finance*, 1935-7, p. 180. The Bank of France lost 2,100 m. francs from March to September 1936.

weight of 65.5 milligrammes. This represented a devaluation between 25 and 34.5 per cent.

The devaluation of the franc was immediately followed by a declaration by the Governments of Great Britain, France and the United States of what is known as the Tripartite Monetary Agreement. By this agreement, the three Governments concerned declared their intention to refrain from competitive currency depreciation and to do their best to defend their exchanges at the existing levels as long as it was not prejudicial to their internal prosperity to do so. It was not clear at the time how this agreement was to work. So long as France continued her embargo on gold, it was impossible for the other two countries to prevent an appreciation of their currencies in terms of the franc by buying gold against them in France. All that they could do was to buy francs against their currencies and hold them, thereby running great exchange risks. They were, of course, free to prevent a depreciation of their currencies by selling gold.¹ This was obviously an anomalous situation. It was, therefore, decided to supplement the Tripartite Agreement by another called the Gold Ear-marking Agreement, which was concluded on October 12, and by which the three Governments concerned agreed that the balances in each national currency owned by the other two Governments would be convertible into gold at the current market price of gold. Both the Agreements

1. Einzig, *Op. cit.* pp. 262-67

are subject to termination at twenty-four hours notice. This agreement enables each country to prevent an appreciation of its currency without having to run any exchange risk. Some other countries like Belgium, Holland and Switzerland concluded similar agreements with the United States.

Immediately after the devaluation of the franc, both the Dutch and Swiss currencies were subject to a selling pressure. There were no exports of gold from Holland from November 1935 to May 1936. In May and June there were small withdrawals; but otherwise the guilder was undisturbed. Even in September, the technical position was fairly sound. The Dutch authorities, however, were afraid of French competition and decided to fall in line with their stronger confrere. The Dutch guilder was accordingly devalued by 20 per cent. Although the extent of devaluation was at first considered inadequate and the guilder was under pressure for some time even after devaluation, still confidence was fully restored in November and there was a considerable repatriation of capital. The Netherlands Bank's reserves began to increase towards the end of the year.

The Swiss authorities were also under no compulsion, on technical grounds, to devalue their currency. There was no material loss of gold since the beginning of the year and the reserves stood at a high level. Prior to devaluation, the Swiss franc was at a premium in terms of the dollar and the forward discount was declining. As the Swiss National Bank

Report for 1936 says, "Devaluation was not put into effect for monetary reasons, but as a result of economic considerations." On September 27, the Swiss franc was devalued between 35.5 and 25.9 per cent of the former parity. Actually, the franc was maintained at a rate of depreciation equal to 30 per cent. One of the first consequences of devaluation was a release of hoarded gold. As the Swiss Bank was prepared to buy gold at the new market price, large amounts of Swiss and foreign gold, coin and bullion, were tendered at the Bank. Swiss funds which were transferred abroad were repatriated and there were continued imports of gold into the country. From September 28 to the end of the year, gold worth about 634 million Swiss francs was added to the reserves of the Swiss National Bank. The influx of foreign capital and the heavy purchases of gold by the National Bank created a plethora of funds in the money market and the discount rate was reduced to $1\frac{1}{2}$ per cent. Due to this easiness of the money market, the banks could carry the burden of their frozen assets without difficulty.

The developments in France offer a remarkable contrast to the post-devaluation experience of Holland and Switzerland. It was inconsistent with the Socialist philosophy that capitalists should be allowed to profit by devaluation. The Government accordingly took stringent measures, making it illegal to hold gold either at home or abroad and requiring all holders of gold to surrender their holdings at the

old mint par. Measures were also taken to prevent a rise in prices. By these measures the Government successfully neutralised all the beneficent effects which are normally expected from devaluation and which are essential to recovery. As long as the sale of gold in foreign markets yielded a handsome profit, it was unnatural to expect that gold would be tendered at the old mint price. Although some timid holders did repatriate their holdings in October, there was, on the whole, no substantial repatriation or dishoarding. The dishoarding and repatriation and the resulting ease of the money market which was noticed in other countries like Holland and Switzerland after devaluation was mainly due to the fact that they scrupulously refrained from any interference with the freedom of the gold or foreign exchange market.¹ A country like France, which was suffering from such recurrent flights of capital had nothing to gain by alienating the capitalists.

In November 1936, France began to export gold again. A wide discount appeared in the forward

1. Cf. The speech of the President of the Swiss National Bank on February 20, 1937. He said, "To expropriate profits realised on gold or to prevent their creation would have been very popular measures, but ineffective, unfair and economically harmful. Certain effects of devaluation, which were essential to economic recovery, — namely, easing of the money market and the decline of interest rates — would not have been achieved. If we wished to reap advantages of devaluation, it was imperative to permit full and complete freedom of gold and foreign exchange operations, and to pay for gold at a price in

exchange which made a transfer of funds profitable. There was at the same time a pronounced rise in the stock markets in foreign countries and funds were moving to London and New York for investment and speculation, if not for safety also. The newly established Stabilisation Fund had to lose gold in November and December in order to maintain the franc at its new level. The Fund did not possess sufficient gold when in November the London credit of 4 milliards fell due for repayment, and the Bank of France had to provide the requisite amount from its own reserves.

In order to encourage dishoarding of gold, the French Government tried a novel expedient in December. They issued a $3\frac{1}{2}$ per cent loan which was to be redeemed after 3 years and the subscriptions for which were accepted in gold. For every 100 francs subscribed, 140 paper francs were to be paid on maturity. This was, however, a poor substitute for payment of the current market price of gold which the public expected. Even the current actuarial value of the 140 francs to be obtained after three years was 7 or 8 per cent less than the actual market value of 100 gold francs. It was no wonder that the loan failed to evoke any response.

line with the average rate of devaluation. The movement of gold with other countries is in no way restricted in Switzerland and foreign exchange operations are subject to no control whatever." (Reported in *Federal Reserve Bulletin*, April, 1937, pp. 318-23.)

The export of gold from France in the last two months of 1936 was the combined result of several factors; the anti-hoarding and anti-capitalist measures taken by the Government, the general expectation of a further devaluation and the consequent discount on the forward exchange, the rapidly improving conditions and favourable gold legislation in the neighbouring gold bloc countries, and the rising tide of speculation and stock prices in the outside world, especially in America. To these, the perpetual budgetary problem of France made its own contribution. In face of a growing volume of national debt which the public was finding it difficult to digest, the French Treasury had no alternative but to finance its deficit by inflationary borrowings from the Bank of France. The Government had also to arrange another credit of £ 40 millions in London in January 1937.

In addition to the various factors stated above, there was another important factor which was encouraging gold exports from France. It was a mistake on the part of the French authorities to keep the exchange rigidly pegged at 105 $\frac{1}{2}$. Thereby they facilitated speculation to a considerable extent. When the rate is allowed to move, the speculator is kept in uncertainty and is dissuaded from operating. Under the rules of the Bank of France, an interval of 48 hours must pass between the delivery of francs to the Bank and the delivery of gold by the Bank. So long as the exchange rate was rigidly fixed, the speculator ran no risk during these 48 hours. He had

a "safe bet". If anything, there was a chance of a handsome profit, if the franc depreciated in the mean while.

In February, however, the French authorities grew wiser in this respect and the exchange rate was allowed to be elastic. The sterling-franc rate moved within a wide range in the month of March. In the same month, they tried another experiment. They made daily changes in the price of gold, with the result that all arbitrage operations between Paris and other centres became impossible. This put an effective brake on the outflow of gold. The price of gold was gradually lowered, so that the holders of gold should feel that the sooner they disposed of their holdings, the better for them. So far as the exchanges were concerned, the unpegging of the franc perhaps created more uncertainty than the former policy of rigid fixation, because there was no guarantee that the French authorities might not allow the franc to sag down to 112 which was the lowest limit under the monetary law of October 1.

By the beginning of March 1937, the French Government had exhausted all the weapons in their armoury of threat, coercion and persuasion to make the capitalist disgorge his gold without profit. At last on March 8, they decided to let the devil have his due. The Bank of France was authorised on that date to offer the full market price for gold. Persons who had previously tendered their gold to the Bank were to be reimbursed for the difference.

between the market price and the old mint price. This conciliatory gesture had an immediate effect. Large amounts of gold began to come out of hoards. There was a considerable repatriation of capital and domestic hoarding of gold was reduced. Indeed, the belated character of this measure spoiled some of its effect and its adoption after such a long hesitation did a great harm to the prestige of the Government.

The sequence of events after March 1937 may be briefly described. In the beginning of April, the commodity markets were seriously disturbed by rumours about the American gold policy. The price of gold in the London market was already depressed owing to the heavy consignments of gold received from Russia. It was reported that the American Treasury was thinking of reducing its buying price of gold or altering the handling charges. The American banks instructed their London agents to refuse to accept any further gold consignments on account of the American Treasury. In spite of the emphatic denial of the Secretary of the Treasury that no change in policy was imminent, the gold scare was not completely removed and the uncertainty created by it about the future price of gold has continued to weigh heavily on the gold market. In the beginning of June, the scare was renewed and shipments to America were again abruptly suspended. The discount on the London price of gold as compared to the American shipping parity widened from 1 or

2d. to 5d. per fine ounce; and the British Exchange Equalisation Account had to support the market by heavy purchases of gold. The gold scares of April and June last were just the natural reactions of the apprehension which is universally felt about the possibility of maintaining the present price of gold in face of the tremendous increase in new production in Russia and elsewhere and the sudden reversal of the hoarding movement. As in April, so in June the immediate cause of the scare was the fear felt about Russian production. The markets were perturbed by a report published in the *Far Eastern Review* estimating the Russian production for 1936 at 10.6 m. ounces as compared to 7.35 m. at which it was estimated in the last Report of the Bank for International Settlements.

After a temporary lull for a few days the situation in France again began to cause anxiety. The heavy rearmament finance led to a considerable increase in imports and the adverse trade balance of France amounted to 4,922 million francs in the first quarter of 1937 as compared to 2,344 million francs in the first quarter of 1936. In his statement to the Finance Committee in April last, M. Vincent Auriol attributed the fall in the value of the franc mainly to this unfavourable trade balance, although the flight of capital and the heavy budgetary deficit were still important factors to reckon with. The ordinary budget for 1937 showed a deficit of 47 milliard francs; besides which there was a large

volume of extraordinary expenditure to be financed. As a result of the sweeping socialist measures of the Blum Government, there was a swift rise in the cost of living. The franc was exposed to recurrent bear attacks and the new Stabilisation Fund was unable to resist the pressure. The franc was allowed to fall from the level of 105 francs to the pound in the first week of March to 110 or 111 francs in May. M. Blum finally decided on some drastic measures to save the situation and approached Parliament in June for a grant of special powers. Parliament refused to grant the powers and there was a change of Government. Under the new regime, the franc was devalued to the level of 129 francs to the pound. The French economy got the much needed stimulus, but it still remains to be seen how far it will help France to solve her really fundamental problems, namely, the budgetary deficit, the unfavourable trade balance and the recurrent flights of capital.

This rapid survey of the financial developments since 1929 is intended to show what a complex set of forces has been in operation behind the international gold movements during the last few years and how the policies of the major economic powers have played their part in aggravating the maldistribution of gold which was already an established fact in 1929. There are certain aspects of this problem which still remain to be touched and to which we turn in the following Chapter.

CHAPTER III
INTERNATIONAL GOLD MOVEMENTS
(*Continued*)

I
CAPITAL TRANSFER TO THE UNITED STATES
AND ENGLAND

LITTLE has been said so far in our discussion of the international gold movements in the last three years of the continuous stream of capital that is flowing towards the United States since the spring of 1935. The stream has increased in volume after the currency alignment of September 1936 and has set a problem of increasing difficulty to the monetary authorities in that country. The great importance of capital transfers from the point of view of gold movements will be obvious from the fact that of the \$ 3,350 million worth of gold and \$ 500 million worth of silver imported into the U. S. from the beginning of 1934 to the middle of 1936, only one-sixth represented payment for her favourable balance of trade and services. The rest was accounted for by capital movements. Further, about 60 per cent of the total capital movement to the U. S. during the same period consisted of short-term funds.

Dealing firstly with short-term funds, it is worth noting that up to 1928 the United States was a net importer of short-term funds. From 1928 onwards the European countries began to repatriate their funds from the United States on a large scale. As a

result of these withdrawals the United States turned from a debtor into a creditor on short-term account in 1932. The period from 1931 to 1933 was one in which the banking system in that country was subjected to a severe strain, by a succession of bank failures, wholesale withdrawals of deposits and hoarding of cash and gold. The United States in those years had a net favourable balance on income account, but due mainly to these capital movements, the country was losing gold to Great Britain and the Continental countries. The net outflow of short term funds during this period amounted to \$2,000 m. as compared to a net *inflow* of American and foreign long-term capital of \$200 m. The foreign balances in the U. S. which exceeded \$3,000 m. in 1929 were reduced to \$487 m. in 1933.

This wholesale repatriation of short-term balances by European countries had a damaging effect on international trade. The shortage of foreign currency which resulted from these withdrawals made it difficult for an important country like the United States to keep up its purchases of foreign goods. The countries which sold their products to the U. S. found their trade balances severely reduced. They used to utilise their receipts from the U. S. for making payments to a third country like the United Kingdom on account of the interest on the loans taken by them or the services purchased by them from that country. It was now difficult for them to effect the transfer except by parting with

gold or making forced sales of their goods. There was a drastic fall in the prices of the commodities produced by debtor countries.

(1) Short-term Foreign Assets and Liabilities of Banks in U. S. ¹

(Amounts outstanding on date nearest end of year; in millions of dollars)

	Foreign Banking Funds in U. S.	U. S. Banking Funds abroad
1929	3,037	1,617
1930	2,737	1,802
1931	1,465	1,239
1932	870	1,053
1933	487	1,082
1934 adjusted ²	573	976
reported.	597	1,123
1935	1,200	762
1936	1,492	657

(2) Movements of International Short-term Banking Funds to and from (—) the U.S.A.

in millions of dollars			
1930	—485	1934	192
1931	—709	1935	970
1932	—409	1936 (9 months)	390
1933	—412		

In 1934, the outward movement of short-term capital from the United States was reversed. We

1. *Federal Reserve Bulletin*, May 1937, p. 399.

2. These figures represent an adjustment of reported figures to permit comparison with earlier years.

have already explained the various factors which contributed to a movement of gold from Europe to the United States during this year. Perhaps the most important among them was the repatriation of American funds which were transferred abroad during the banking crisis of 1933.

Nevertheless, it is clear from the figures quoted above that even in that year the amount of banking funds held abroad by the U. S. were far in excess of the foreign banking funds in the U. S. It was only since 1935 that the United States has become a net debtor on short-term account.

During 1935 the short-term assets of foreigners with American banks almost doubled, while the United States short-term assets abroad fell by 30 per cent. According to the *Balances of Payments* for 1935, there is no doubt that the inflow of funds from Europe in 1935 was purely of the nature of capital flight due to monetary and political apprehensions, and it is remarkable that it took place in spite of the fact that the interest earned on short-term funds was generally higher in the European countries from which the funds moved than in the United States. It has been estimated by the Department of Commerce that about one-third of the net inflow of banking funds in 1935 resulted from the repatriation of American funds. The American funds which were in a frozen state in Germany and the Latin American countries were also gradually released, and transferred to the U.S. during this period. During the political tension

caused by the Abyssinian crisis in September and October 1935, large amounts were shifted from London to New York for safety.

Contrary to what would appear from the sensational accounts that one hears about the flight of capital from the gold currencies, only one-fifth of the capital transferred to the United States since the end of 1933 was drawn from the gold bloc. Most of the gold bloc capital has gone to England. The various financial and political crises which brought about this transfer have already been explained and need not be repeated here. The flight of funds was intensified in the few months following the Belgian devaluation in March 1935, during which period the currencies of Holland, Switzerland and France were subjected to strain one after another. The budgetary crises in Holland and France in the last quarter of 1935 further accentuated the movement. For the reasons already explained above,¹ the movement to the U. S. was checked in the first quarter of 1936, during which period, although much capital was transferred from France, it went to London instead of New York. The movement of funds from the gold bloc was resumed in April, 1936 when confidence in New York was restored. Since then it has been continuous. Even after the currency alignment of September 1936, there has been no material reduction in the balances held in America by the European gold bloc countries.

1. See page 54 *supra*.

Although the major portion of French capital is reported to have sought refuge in the United Kingdom, Switzerland, and other European countries, it is interesting to note that the amount of gold exported by France to the United States (13.7 milliard francs) in 1935 was approximately of the same magnitude as the amount of capital exported by her (14 milliard francs). The reason is that the countries which were receiving French capital were simultaneously exporting capital to the United States. Consequently, while France was sending her capital to the United Kingdom and other countries, she had to send her gold to the United States.

The transfer of balances from London to New York (which, incidentally, represented nearly one quarter of the total balances transferred to New York between the end of 1933 and September 1936) has been considerably helped by the situation in the foreign exchange market. The forward sterling was at a discount since the end of 1934. Owing to the difficulties of the gold bloc countries, sterling had risen to an unnatural level and it was, therefore, expected that it would come down when the gold bloc countries would be relieved of their troubles. Being afraid of depreciation, the American banks which held funds in London, were selling sterling for future delivery. This, in conjunction with ordinary speculative* operations, greatly increased the supply of forward sterling in relation

to the demand for it and it went to a discount. When the discount was wide enough to offset the excess of the interest rates in London over those in New York, the American banks began to shift their funds from London. Even the British people had an inducement to convert their funds into dollars, because sterling sold at spot rate could be repurchased for future delivery at a lower rate. Lately, there has been a change in the situation, the forward rate having considerably improved in the last few months.

Quite a substantial proportion of the short-term balances in New York, moreover, represents the working balances belonging to European and non-European countries which have been built up in a slow and regular process, unlike the British and gold bloc balances which have come in big spasmodic movements. Due to the precarious position of other capital centres, New York has come to be regarded as a safe repository for such funds.

Turning now to the movement of long-term capital, it has been estimated that only forty per cent of the total amount of capital that was transferred to the United States from the beginning of 1934 to September 1935 was of a long-term character. It is only recently, since September 1936, that the movements of long-term capital have begun to represent a preponderant proportion of the total capital movement to the United States. There are two important things to be noted about the foreign long

term investments in the United States. For one thing, the flow of long-term capital to that country has always been steady and continuous since 1930, and to some extent independent of the movements of short-term funds which have been of a sudden and spasmodic nature. During the period 1930-33, when there was an export of short-term funds from the United States to the extent of \$ 2,000 m., long-term capital worth \$ 200 m. flowed into the country. Similarly, when the influx of foreign funds into the U.S. was temporarily arrested in the first few months of 1936, the flow of long-term capital was undisturbed. It seems that apart from the temporary ebbs and flows of business, foreign investors have never become nervous about the soundness of the industrial situation in that country.

Movements of Investment Capital to and from (—)
the U. S. A.

in millions of dollars

1926	—602	1932	217
1927	—723	1933	49
1928	—662	1934	202
1929	—137	1935	462
1930	—267	1936 (nine months)	464
1931	219		

It will be observed that the peculiar magnitude of the gold movement to the U. S. since April 1935 was due to the fact that while for many years before that date the influx of long-term capital was more than offset by an outward movement of short-term funds, after

April 1935, the inflow of long-term capital was accompanied by an even larger inflow of short-term funds.

Another interesting feature of the long-term investments in the U. S. is that only a small proportion of them has been acquired during the depression. Of the \$ 5,035 m. at which the total foreign investments on the 31st December 1935 were estimated, only \$ 500 m. had come into existence since the end of 1933. The rest were in the United States before 1933. (The total foreign investments are now estimated at somewhere near \$ 6,500 m.) This means that even during the crucial years 1930 to 1933 when the industrial situation in America was anything but satisfactory, and confidence was at a low ebb, foreigners on the whole did not materially reduce their investments in that country. Consequently, although the inflow of short-term funds has been much greater than that of long-term capital during the depression, the net long-term liabilities of the U. S. were nearly four times as large as her short-term liabilities at the end of 1935. Indeed, in 1930-31, when prices were declining, some foreigners must have sold their holdings, but at prices which only made it attractive for others to buy; so that the total volume of foreign investments remained approximately unchanged.

While the foreign investments in the United States have shown a steady growth, the investment of American capital in foreign countries has

considerably diminished in the last few years. In 1927 and 1928 new foreign issues used to be floated in America at a rate of more than \$ 1,000 m. a year. While the net outward movement of investment capital amounted to \$ 662 m. in 1928, it was reduced to \$ 137 m. in the following year. During the post-war period many debtor countries like Germany and the countries in Latin America depended on an import of capital from the U. S. for the settlement of their international account. During the boom conditions which prevailed in the U. S. in 1929, the export of long-term capital from that country was heavily reduced. There was a slight revival in 1930, but after that year there was again a progressive reduction in the new issues floated in America on foreign account. After 1932 the market for foreign issues disappeared altogether from America.

America had been a net exporter of capital ever since the war, but since 1931 it has changed the role and become a net importer of capital. Apart from the general loss of confidence in foreign investments, one has also to remember that the net lendable surplus of the United States was greatly reduced during the early years of the depression.¹ The cessation of the long-term capital export from the U. S. was indeed a revolutionary change in the international situation, because throughout the

1. The surplus of the United States in her trade with Europe fell from \$ 930 millions in 1930 to \$ 313 millions in 1933.

post-war period up to 1931, the movement of American long-term capital was consistently outward except in one year 1923.

Since 1931, there was a heavy liquidation by Americans of their long-term commitments in other countries. The total foreign investments of the U. S. during the four years, 1931-34, fell by over 13 per cent. The heavy outflow of short-term capital which was taking place at that time was partly offset by this inflow of long-term capital. The inflow was mainly due to the repurchase by foreigners of the securities floated by them in the United States. Accurate statistics about the repurchase of securities by debtor countries are not available, but an examination of the relevant statistics in the case of the United States shows that the reductions in the nominal value of the outstanding investments of the U.S. from 1931 to 1934 were far in excess of the net cash payments to the country corresponding to such reductions. The net inward payments in no year exceeded 40 per cent of the net sales of investments; which means that the average value of the securities sold was much lower than that of the securities bought. During these years Americans were fast getting rid particularly of such foreign securities as had fallen heavily in price.¹

The long-term capital movements during these years of the depression were mainly of the nature of a sale by creditors of the securities which were

1. *Balances of Payments*, 1934, pp. 24-26.

depreciating. Debtors themselves found it an attractive proposition to repurchase these securities. Due to the loss of confidence in international finance, it was everywhere the case that the securities of debtor countries were quoted at a lower rate in foreign markets than in their home markets. Besides, it was difficult for debtor countries, especially in New York, to have their loans converted to a lower interest basis. It was, therefore, convenient for them to float loans at home at a lower rate of interest and to utilise the proceeds in repurchasing their securities in foreign markets. Most of the Latin American countries have reduced their debt to the U. S. in this way. The movement was reinforced in the year 1933 when the depreciation of the dollar reduced the cost of purchasing foreign dollar bonds in terms of other currencies.

As regards American securities, there was a keen demand for them from foreigners due to a rapid fall in their quotations from the autumn of 1929 to 1931 inclusive. In 1932, however, the U. S. purchases of domestic securities are recorded to have slightly exceeded their sales. During 1933, although there was a flight from the dollar in the spring of that year, there were considerable speculative purchases by foreigners of dollar securities, particularly shares, later in the year.

But the movement into American securities proper really gained strength in May 1935. Since that month purchases of American securities

by foreigners have exceeded their sales. They reached their maximum for the year in the last quarter of 1935, when owing to a combination of political and financial disturbances in Europe, gold was moving across the Atlantic on a large scale. As said above, the general movement of capital into American security markets continued in 1936 also, although the inflow of short-term capital was checked in the first quarter of that year. It was in 1936 that the net inflow of investment capital reached its highest level since 1931. While the net inward movement of investment capital amounted to \$ 462 m. in 1935, it amounted to \$ 464 m. only in the first 9 months of 1936.

The foreign purchases of securities in America have shown a tremendous increase in volume since last September. Since the re-election of President Roosevelt the security market in the United States has assumed a buoyant tone and prices are continuously on the up-grade. There has been a fairly sustained demand for American securities; and foreign investment in these has become an important factor in the movement of gold to the United States.¹

The change in the position of America from a net exporter of capital funds into a net importer has raised the very difficult question of the future tariff policy of the country. •There is no doubt that the

1. The following table shows the distribution of foreign investments in the U.S.A. as between certain important

foreign debtors of the U.S. cannot in the long run meet the service of their debts in the form of gold. If default is to be avoided, the only policy that the U.S. can sanely pursue is to allow them to develop a favourable balance with her. But how is that to be achieved? Not certainly by a reduction of exports, although the export trade of the United States does not amount to more than 7 per cent of her total domestic production. An increase in imports by a liberal reduction in tariff barriers appears to be the only solution and it has been advocated by many economists who have examined the question. Lately, since 1935, there has been a welcome change in the situation, creditor countries as a whole having increased their adverse trade balance or decreased their favourable trade balance with debtor countries. The export surplus of the U. S., in particular, fell by more than half from 1934 to 1935 and was succeeded by an import surplus in the first eight months of 1935. The same tendency was

countries, as on the 31st December 1935.

(In millions of dollars.)

	Total	Great Britain	Canada	Gold bloc	Other countries.
Common stocks	2,015	372	408	552	683
Preferred ..	329	146	66	64	53
Bonds	607	91	43	338	129
Direct investments	1,045	362	322	276	85
Other ..	1,039	403	161	235	240
Total	5,035	1,374	1,006	1,465	1,190

noticed in other creditor countries including the United Kingdom, France, Netherlands, Belgium, Switzerland and Sweden.

We may now take a synoptic survey of the essential features of capital movements from countries other than the United States in the last few years. As regards long-term capital, it is well-known that, as in the U. S., so in other countries new issues have ceased to play a prominent part in international capital movements. Soon after the departure of the pound from the gold standard an unofficial embargo was imposed on the flotation of new foreign issues in England.¹ The share of the overseas loans floated in London for the account of foreign (i. e. non-British) countries fell from 69 per cent in 1930 to 21 per cent in 1933 and 7 per cent in 1934. It rose to 14 per cent in 1935.² The French issues for foreign account have also greatly diminished. They were only \$ 9 millions in 1935 as compared to \$ 146 m. in 1931.

1. Mr. Chamberlain appealed to the capitalists when the War loan conversion was announced, not to make any new issues until the conversion was complete. In September 1932, when the conversion was over, the ban on domestic issues was raised, but that on foreign issues was retained. In May 1933, the ban was extended to purchases of large blocks of securities from foreign holders for resale in Great Britain. In April 1933, Government permitted the issue of a Danish Government loan, as a special case. On June 9, 1934, the Chancellor of the Exchequer announced that the embargo would be relaxed in the case of two classes of foreign borrowers; one, the borrowers within the sterling area and the other those borrowers who would spend the proceeds in a way that would be directly beneficial to the British industry.

2. See also Table on p. 82.

NEW CAPITAL ISSUES IN THE U.K.¹

Year	Amounts invested (£000 omitted)				Percentage of total issues		
	Home	Dominions and Colonies	Foreign countries	Total	Home	Dominions and Colonies	Foreign countries
1911-12	38,000	67,000	95,000	200,000	19.0	33.5	47.5
1919-21	204,098	53,913	21,171	279,182	73.1	19.3	7.6
1922-26	106,067	69,202	51,958	227,227	46.7	30.4	22.9
1927	176,043	87,744	50,927	314,714	55.9	27.9	16.2
1928	219,135	86,110	57,274	362,519	60.5	23.7	15.8
1929	159,402	54,412	39,935	253,749	62.8	21.5	15.7
1930	127,356	70,047	38,757	236,160	53.9	29.7	16.4
1931	42,588	36,832	9,246	88,666	48.0	41.6	10.4
1932	83,817	28,873	348	113,038	74.1	25.6	0.3
1933	95,059	29,814	7,996	132,869	71.5	22.5	6.0
1934	106,741	40,391	3,058	150,190	71.1	26.9	2.0
1935	161,934	18,038	2,852	182,824	89.0	9.4	1.6

1. Richardson: *British Economic Foreign Policy*, p. 73.

The repurchase of securities by debtor countries which was a distinctive feature of the flow of long-term capital to the U. S. during 1931-34, was also noticed in the case of other countries. While in the U. S. the amortisation receipts considerably exceeded her new bond issues for foreign account, in the United Kingdom they reached figures not far below those of new issues. The circumstances which induced the debtor countries to repurchase their bonds have already been explained above. Among the countries which repurchased a portion of their outstanding debts may be mentioned the Argentine, Australia, Germany and India.

Like the U. S., the United Kingdom also appears to have liquidated mainly those securities which have fallen much in price. The actual cash receipts have fallen far short of the reduction in the nominal value of foreign investments.

The volume and direction of capital movements have been considerably influenced by the changes in the monetary and tariff policies of the big trading nations. The overseas investments of the United Kingdom are largely in agricultural countries and her ability to realise the income from these investments depends on the extent to which she allows an import surplus to arise in her international trade. The normal mode of transferring this income, till 1929, was that the overseas countries which were indebted to the United Kingdom used to have a favourable balance with countries other than the

U.K. and these latter used to have a favourable balance with the U. K. It was pointed out by an authority in 1929 that each year the U.K. collected in the form of American merchandise about \$ 500 millions of the revenues from her overseas investments and her merchant marine. After 1931, the U. K. changed its tariff policy with the result that between 1931 and 1933, her passive balance with the United States fell by one half and that with the European continent by 72 per cent. The reduction in exports which these countries suffered was immediately reflected in a reduction in their imports from the agricultural countries. There was a shrinkage in the trade surpluses of the agricultural countries and it became a difficult problem for them to meet the service of their loans. Fortunately, there has been a compensatory change in the situation, in the form of an increase in the passive balance of the U.K. vis-a-vis the other parts of the British Empire. So far as the Empire countries are concerned, therefore, the service of their debt to the U. K. now is met by a direct transfer, instead of the triangular operations of the pre-depression days. No such relief has been available to agricultural countries outside the British Empire and the British holders of investments in these countries have suffered a great deal as a result of default on their part. The problem before Britain is how to reconcile the interests of her investors with those of her industrialists who will vehemently oppose any change in her present tariff policy.

Another example of the close inter-relation between trade and capital movements is to be found in the case of Germany. Before 1929, Germany had a large trade deficit and her account was largely settled by capital imports from the United States and other European countries. During the period, 1923-25, French capital amounting to \$500 m. annually was lent, largely on short-term, to other creditor countries and re-lent by these to Germany. After the stabilisation of the franc in June 1928, this flow of capital from France suddenly stopped and the capital export from the U. S. was also heavily reduced. Germany had accordingly to utilise her trade surplus with other European countries to meet the service of her debts to them and was unable to purchase her requirements of raw materials on the old scale. The trade of agricultural countries with Germany was seriously affected and their transfer difficulties were aggravated.¹

During the last two years the long-term investments of the principal creditor countries have again assumed an upward swing. But the flow of long-term capital is not directed to debtor countries, which are still in need of it, inspite of the recent rise in international prices; it has mainly taken the form of speculative purchases of United States shares by the creditor countries in Europe. A good deal of long-term capital was also attracted to Sweden where the sales of domestic securities to foreigners amounted to double their purchases from foreigners in 1935.

1. Cf. *Balance of Payments*, annual, *passim*.

The *League of Nations Balances of Payments* for 1935-36 has estimated the total long-term investments of all creditor nations at \$30 milliard at the old parity. The long-term investments of the U.S. amounted to \$7.6 milliard gold at the end of 1935. According to Sir Robert Kindersley's estimates, Britain's foreign investments at the end of 1933 were £ 3,386 millions.

As regards short-term capital, the extremely erratic nature of its movements between capital centres is too well known to need emphasis here. During the period 1930-34, the total amount of outstanding short-term indebtedness was reduced from 70,000 million to 30,000 million Swiss francs. (There was no material change in 1935). The reduction was partly due to currency depreciation and partly to the reduced needs of international trade owing to the shrinkage in its volume. One of the main factors in the reduction, however, was the rapid liquidation of their foreign short-term assets by the European central banks to which we have already made a reference in our account of the gold movements in 1932-33. The amounts held by foreigners in American banks were also reduced between 1929 and 1933. Russian commercial debts which at the end of 1931 amounted to 1,400 million roubles, fell to 450 million at the end of 1933. Germany has also brought down her short-term debt through the sale of registered marks at depreciated rates.

The short-term position of London has undergone many interesting changes during the last few years. Just before the departure of England from the gold standard, London's position as an international capital centre had become extremely precarious. Before the War the short-term finance of London consisted mainly of acceptance business in which its assets and liabilities were more or less evenly balanced. During the post-war period, however, London became an international centre for holding deposits and there was a great increase in London's liabilities to foreigners in the form of deposits, in addition to its liabilities in the form of sterling bills, with the result that London became a net debtor on short-term account.¹ The major portion of these liabilities was incurred from 1925 to the end of 1927 when the Bank of France was accumulating short-term balances abroad. There was at the same time a reduction in the annual surplus of England for long-term foreign investment and it was apprehended that the large volume of foreign issues which were floated in London in those years and the heavy purchases of foreign bonds made by the British investors in the United States were probably financed out of these liabilities. In other words, London was borrowing short and lending long. The Macmillan

1. *The Macmillian Report*, pp. 11-14, 148-9. *Monetary Policy and the Depression* (The Royal Institute of International Affairs), Appendix I, *Britain's Industrial Future*, N. F. Hall's *Exchange Equalisation Account*, Chapter II.

Committee examined this contention and found that the net purchases of foreign bonds were really paid out of the current accruing surplus on income account. So far as the short-term account was concerned, however, they expressed grave anxiety regarding the heavily unbalanced position of London. The situation was further complicated by the existence of a large volume of Treasury bills and short-term unfunded debt in the London money market during this period.¹ Foreigners who wished to hold sterling balances could buy these high-yielding short-term securities. Owing to their short-term character, there was little or no chance of capital loss in the event of a rise in the general level of money rates. These short-term Treasury obligations were, therefore, a peculiarly attractive form of investment to foreigners who cared more for security and liquidity in those days than for income and their demand was fully satisfied by the excessive supply of these securities that was available in the London market. The Treasury had to keep a large volume of debt in this form because of the imperative necessity in those days of keeping down the annual interest charges. This growth of short-term debt and the simultaneous accumulation of foreign balances in London created some difficult problems for the monetary authorities. A change in the bank rate had no great influence on the capital value of short-term securities, and as the foreign balances

1. N. F. Hall, *Op. cit.* pp. 8-22.

were mainly invested in such securities, the monetary authorities had no effective control over their movements to and from London. Whenever, besides, there was an expectation of a rise in money rates, foreigners converted their sterling balances from bills into bank deposits, thereby making the situation worse. A rise in the bank rate may at least check the liquidation of bills by depressing their value, but when balances are held in the form of bank deposits, raising the bank rate was hardly an effective means of checking their withdrawal.

In 1931 there was a rapid withdrawal of these balances from London, while the foreign short-term assets of London became suddenly frozen. The result was the abandonment of the gold standard in September. The withdrawal of French balances from London and elsewhere which preceded this crisis and which proceeded with great vigour in 1932 and 1933 has already been explained elsewhere. In 1932, sterling regained the confidence of the world and large foreign funds flowed to London. There was a pronounced rise in the value of sterling, although the Treasury and the Bank of England were buying dollars and francs to repay their New York and Paris credits of the previous year. The pound rose further when it became known that sufficient foreign exchange had been acquired to repay these credits. This showed that there was a speculative transfer of funds to London in the expectation of a rise in the value of the pound. The lessons of 1931

were not lost on the British authorities. By instituting the Exchange Equalisation Account they arranged to offset this transfer of funds and the resulting fluctuations in exchange.

The depreciation of the dollar in the spring of 1933 reinforced the tendency of foreign funds to flow to London. The European gold standard countries, particularly, France, Switzerland, Belgium and Netherlands, also attracted large amounts of refuge capital in 1931 and 1932, but their position weakened in 1933. The foreign funds which accumulated in London in 1932 and 1933 represented largely the exchange reserves of the central banks and governments in the sterling area. There was a large movement of funds to London from South Africa and India in 1932 and 1933. The Treasury and reserve balances of the Indian Government rose during the three years ending March 31, 1935, by £ 53 millions. The sterling balances held as primary or secondary cover by the Union of South Africa, Australia, India, Egypt and the four Scandinavian countries were estimated by the Bank for International Settlements to have risen from £ 50 m. at the end of 1931 to £ 120 m. at the end of 1933 and to £ 140 m. at the end of 1934.

It is interesting to note that Great Britain's balance of payments in 1933 was so situated that the inflow of funds belonging to the Governments and banks in the sterling area had necessarily to be covered by an import of gold. In 1933, Great Britain

was able to wipe out completely the deficit on account of goods and services and net Government receipts, which had arisen in 1931, and hence other countries had to sell gold to her to obtain their sterling reserves. The Bank of England increased its gold stock in 1933 by £ 71 millions. Besides, the Exchange Equalisation Account is also known to have used a part of the inflow of funds from the sterling area to acquire large amounts of foreign assets. In 1934, however, sterling was weak and a portion of these assets had to be parted with. The Fund had also to sell gold from its deposits in France to the value of £ 105-110 m. This outflow of funds was not due to any withdrawals by the countries in the sterling area; in fact, the latter exported a further amount of £ 20 millions to London during the year. The deficit in the current international account also did not amount to more than £ 1.2 million. The outflow was due mainly to a repatriation of American funds.

In 1935, the accumulation of funds in London by the countries of the sterling bloc slowed down to some extent. The reason was that the countries concerned utilised their available funds for reducing their external debt or for purchasing gold. The assets of the Indian Government on account of Treasury and reserve balances held in London, which had risen by £ 15 millions during the financial year ending 31st March 1935 and by £ 28 millions and £ 10 millions respectively in the two preceding years.

rose by a little more than £ 1 million in 1935-36. At the same time, the London liabilities of the Indian Government on account of sterling loans, railway annuities etc. fell by £ 7.5 millions. In using the surplus funds in 1935-6 for reducing the external debt of India instead of adding them to the Treasury balances in London, Sir James Grigg, the present Finance Member of the Government of India, made a distinct improvement upon the policy of his predecessor. Sweden utilised a part of her funds for purchasing gold, but the Finnish Government followed the Indian example and reduced its long-term indebtedness.

As has been already mentioned elsewhere, London was exposed to an outflow of funds in September 1935 due to the transfer of short-term capital to New York on the eve of the Abyssinian War. This, however, came to an end in October. Throughout the major part of 1935 and 1936, there was an influx of gold in London, in spite of the reduction in the inward movement of the sterling bloc capital. It was partly due to the repatriation of gold held in Paris by the Exchange Equalisation Account, but the main reason is to be found in the financial crises in the gold bloc countries which have been already described. At present the flow of international capital is prevailing in the direction of London and New York and gold is pouring into these two centres as the necessary medium for effecting the transfer of funds.

The reader will see from this study of recent capital movements what revolutionary changes have taken place in the policies of leading creditor nations in the matter of international investment and in the position of different capital centres as the repositories of international floating funds. For any clear appreciation of the significance of international gold movements, it is highly essential to have a vivid understanding of the important changes in capital movements, because in these is to be found one of the root causes of the present disequilibrium in international relations and it is in a conscious control of these movements that the hope of an ultimate restoration of a satisfactory international standard really lies.¹

1. The information used in this section is derived from the Reports of the B. I. S., the files of *Federal Reserve Bulletin*, the annual volumes of *Balances of Payments* and the articles published in the *Economist* from time to time.

II

GOLD MOVEMENTS FROM GERMANY

A reference has been made elsewhere to the international runs on German banks in September 1930 after the General Election and again in July 1931 during the panic created by the failure of the Austrian Credit Anstalt. In the course of our discussion of the financial developments in subsequent years we had very little to say about Germany; the reason being that during the major portion of this period Germany had strongly entrenched her national economy by means of various artificial devices (in the form of exchange restrictions) and consequently, the financial developments in other countries could have no material effect on the movements of capital or gold in and out of that country. This does not, however, mean that Germany was free from gold losses. The gold reserve of Germany which amounted to \$ 544 m. (at the old parity) in 1929 was reduced to \$ 528 m. and \$ 234 m. in 1930 and 1931 mainly due to the withdrawals mentioned above, and from that level it came down by successive stages to only \$ 19 millions in 1935. During 1936 it fell further by about 20 per cent.

In 1931, the strain on the economic system of Germany was considerably relieved by the cessation of reparation payments after the moratorium of July 1931 and the conclusion of the Standstill Agreements with foreign creditors in August 1931.

Until 1931, the deficit in Germany's balance of payments was mainly due to reparation payments. The suspension of these payments converted this deficit into a surplus. There was a substantial excess of merchandise exports, to add to the receipts from shipping and other services. In 1932, however, the excess of merchandise exports was reduced to one-third of its level in 1931 and it fell still further in 1933. The outflow of gold from Germany from 1932 onwards was mainly due to the inadequacy of her foreign balance of trade and services to meet the service of her external debt.

The decline in the gold reserves of the Reichsbank in 1932 and 1933 was caused mainly by the repayment of the credit granted to the Bank by a group of central banks in the crisis of June 1931.¹ This credit, originally for an amount of \$ 100 m. was reduced to \$ 86 m. by the end of 1932 and to \$ 70 m. by March 1933. In the first half of April, the credit was entirely liquidated. In July 1933, the gold reserves were further reduced by the repayment of a credit granted to the Gold Discount Bank by a syndicate of American private banks in April 1924. The export surplus of Germany was hopelessly insufficient to meet the service of her foreign debt. It is interesting to note that the gold losses of Germany were due entirely to her own difficulties and the country was more or less completely immune from the speculative crises which were

1. The Annual Reports of the Reichsbank for 1932 and 1933.

bringing about gold exports from Holland, Switzerland and France during the same period. Faced with such repeated losses, the Reichsbank decided on July 1, 1933 (when its gold reserve had already declined to \$45 m. from the level of \$196 m. at the beginning of the year) to declare a partial moratorium on the payment abroad of both the principal and interest of a large part of foreign debt, except that portion of it which was covered by the Standstill Agreements of August 1931, and except credits used in current financing of foreign trade. As a result of this moratorium, the pressure on the Bank was considerably relieved. The Bank steadily acquired gold in July and August 1933. Except for a small export of \$676,000 in August, there was no export of gold for the rest of the year. In September, the Bank increased its gold reserve by converting a portion of its foreign exchange holdings, worth about \$18 m., into gold. At the end of the year the reserves amounted to twice as much as in June.

Germany's foreign trade began to show an unfavourable balance in the beginning of 1934 for the first time in the previous four years. In the month of March 1934, the greatest reduction in the central bank reserves in Europe was to be found in Germany. Throughout the first half of 1934, the German reserves were declining. Since June 1934 Germany adopted the practice of allowing imports only to the extent of foreign exchange made available by exports and

services. These restrictions, however, had a very serious loophole. They left the nationals free to import as much as they liked, but restricted only the payment for the goods imported. This led to an accumulation of commercial debts. It was, therefore, decided to stiffen the restrictions. From September 24, 1934 onwards, the Reichsbank released foreign exchange in payment for imports only when exchange permits were granted previous to the importation of goods.¹ These measures were completely effective, inasmuch as the decline in gold reserves was promptly checked after their adoption and the reserves showed a steady increase from June 1934 to September 1935. Several other measures such as the system of blocked currencies were also put into force to minimise the loss of gold.

In their negotiations with other countries, the German authorities have never lost sight of the imperative necessity of preserving and strengthening the country's gold reserves. They can achieve their object only by maintaining or increasing their trade surplus as much as possible. They have, therefore, concluded compensation trade agreements with countries with which Germany had an unfavourable balance, the equality between exports and imports being established both by increasing German exports and reducing imports. With countries, on the other hand, with which Germany has a favourable balance:

1. *Federal Reserve Bulletin*, May 1935, p.285.

they have insisted on maintaining the balance.¹ In spite of the adoption of these tactics, however, there has been no material impression on the gold reserves of the country. Since September 1935, the gold reserves again began to decline and they now stand at \$ 27 m. (at the new parity) as compared to \$ 38 m. a year and half ago. The growing deterioration of Germany's foreign trade is the sole explanation of this decline in her reserves.

In her present situation, there is no doubt that Germany requires a large stock of gold. When, as a result of the war, she lost her colonies, she was in effect deprived of many of her traditional sources of essential raw materials. She has had to rely on her commercial pacts and alliances with the raw material producing countries in Central and Eastern Europe,—alliances which may or may not avail in the event of a major conflict. If a war breaks out, it is only by gold that Germany can buy her raw materials. Her present gold stock of \$ 27 m. is hopelessly inadequate from this point of view.²

1. *Einzig: World Finance 1935-37*, Chapter on Germany.

2. There is another country about which information is extremely meagre. Ever since the application of economic sanctions, Italy has ceased to publish information about her gold reserves. It is, however, now known that the gold reserve of the Bank of Italy amounted to 2,380 millions old lire on the 20th February 1937 as compared to 3,936 millions on the 20th October 1935. This means that the Bank of Italy has lost nearly 40 per cent of its gold during the period. In the case of Italy also the main reason for her loss of gold is the inadequacy of her exports to purchase the essential foodstuffs and raw materials from other countries. (Figures from the *Economist*, 13-3-1937, page 593.)

CHAPTER IV GOLD ABSORPTION AND EXCHANGE EQUALISATION

I

EXCHANGE EQUALISATION ACCOUNTS IN ENGLAND AND OTHER COUNTRIES

WITH the departure of England from the gold standard on September 21, 1931, sterling and several other currencies that were linked with it were left entirely at the mercy of speculators. It seemed for a time that a state of more or less complete chaos in exchange rates was the only alternative to the rigidity which characterised the old regime and it was the necessary price that the nations had to pay for the freedom from the painful shocks of deflation that they had to suffer as a result of that rigidity. It soon began to be realised, however, that it was possible to discover a *via media* between the two extremes and the various types of exchange funds that were evolved during the course of the depression were the concrete results of the zealous search of monetary authorities for a mechanism that will ensure a reasonable exchange stability, without in any way hampering the pace of internal recovery. As time went on, their art of exchange management was gradually refined by experience and their objects were more clearly defined, but what is more important to note is that although originally conceived purely as instruments of exchange control, they have now

become huge repositories of secret gold reserves and, as such, have come to serve, at least in some countries, as important safety valves between the channels of gold distribution and those of monetary circulation. In what follows I will try to give a brief account of the important exchange funds in the world and to explain to what extent their operations influence the monetary and credit situation in their respective countries.

The British Exchange Equalisation Account was established in England in 1932 and was followed by the Foreign Exchange Fund of the Argentine in November 1933, the United States Stabilisation Fund in January 1934, the Belgian Exchange Equalisation Fund in April 1935, the Canadian Exchange Fund in July 1935, the Stabilisation Fund of France and Exchange Funds in Holland and Switzerland in September 1936. Except the British and Canadian Funds, most of these funds were started soon after the official devaluations of the currencies of their respective countries.

The British Exchange Equalisation Account was instituted under the Finance Act of 1932. Its resources originally consisted of only Treasury Bills worth £150 millions. Besides, the balance of the old dollar exchange reserve, amounting to £33 m., was also made available to it. It is worth noting that unlike many other exchange funds, the resources of the British Fund were not found out of the profits arising from a revaluation of the gold reserves. In fact, the gold reserves of the

Bank of England have not been revalued to this day. In May 1933, Parliament increased the borrowing powers of the Account to £ 350 m. and in June 1937, to £ 550 m. The object of the Account is to counteract seasonal fluctuations, speculative operations and the movements of refuge capital that are likely to disturb the exchanges. The Account has never tried to offset tendencies of a long-term character that owe their origin either to some fundamental change in the balance of trade or in the movements of investment capital. Such tendencies are only moderated in their effect, so that the resulting appreciation or depreciation of sterling takes place smoothly.

When sterling tends to appreciate, due, for example, to some temporary influx of foreign funds, the Account tries to prevent the appreciation by selling sterling against gold or against foreign currencies which are as far as possible immediately turned into gold. It finds the sterling required for these operations out of the proceeds of the Treasury bills which it floats. The Account is also authorised to borrow from the Bank of England. It may buy gold either in London or abroad. On the other hand, when sterling tends to depreciate, due, for example, to some movement of funds out of London, the Account tries to prevent the depreciation by buying sterling against gold or foreign currencies and sterling thus acquired is used to redeem a portion of its outstanding Treasury bills. It follows, thus, that the

Account's ability to prevent an appreciation or depreciation of sterling depends on whether or not it possesses a sufficient supply of sterling or gold as the case may be.

In the second quarter of 1932, when gold was flowing to England and sterling had a tendency to rise, the British authorities correctly gauged the tendency to be a temporary one and tried to prevent the rise. This strength of sterling was soon followed by a relapse in the second half of the year, when funds were moving out of London due to the lowering of interest rates (which was brought about to facilitate debt conversions), seasonal factors, and the anticipation of the war debt payment. The Account was then unable to offset the fall completely, because its resources were mainly in the form of sterling and it had not yet been able to acquire a sufficient stock of gold or foreign exchange. It has been remarked that had the rise in sterling not been checked in the first half of 1932, the set-back in the second half would have been much more severe. Thus, the charge that was often levelled at the Account, especially in America, that it deliberately tried to depress the value of sterling in order to increase the competitive strength of the British industry, does not appear to be well founded.¹

1. Professor Sprague of the Harvard University in his evidence before the U. S. House of Representatives Committee on Banking and Currency, said, "It was never the purpose of the British Equalisation Account to depress the value of the pound."

Early in 1933 the pound began to rise again, due mainly to the confidence created by the payment of the war debt instalment in gold in December 1932 and the fears felt about the future of the dollar. It was appreciating both in terms of the dollar and franc, but the Account chose to moderate the appreciation more by buying francs than dollars. The reason probably was that the pressure against the dollar was much stronger than that against the franc and hence it was more economical to support the latter than the former. In 1933, sterling was allowed to rise slowly from 336.14 in the beginning of the year to 511.60 at the end. The Account increased its gold stock during this period. During a large part of 1934, the pound was sagging in its exchange value and the Account had to support it by selling francs as well as gold. The depreciation of sterling in March 1935 was one of the main factors that precipitated the Belgian crisis. The Account correctly judged that the level of 511.60 reached in December 1933 was really too high for sterling and hence made no attempt to maintain it. It simply used its resources to mitigate the naturally downward trend of sterling. Sterling recovered in May 1935 and was strong in the major part of 1935 and 1936 when the currencies in the gold bloc were subject to recurrent flights of capital. The operations of the Account in 1935 and 1936 in preventing the undue appreciation of sterling that would have resulted

from the temporary influx of short-term funds from the Continental countries led to a considerable increase in its gold stock. In September and October 1935, during the political tension caused by the Abyssinian war, when there was an efflux of funds from London, the gold and foreign exchange resources of the Account must have been reduced to some extent. Over the period as a whole, the Account was receiving gold. Even after the gold bloc devaluation of September 1936, although the Dutch balances in London were repatriated, there was no material reduction in the balances held by France and hence sterling did not come under pressure on this account. The inward movement of foreign balances has been continuous in 1937 and in May last the sterling resources of the Account were nearly depleted in continued purchases of gold. The British Government had, therefore, to increase the borrowing powers of the Account by £ 200 m. in June last. ¹

The operations of the Account have always been shrouded in utmost secrecy. On June 27, however, Sir John Simon, the Chancellor of the Exchequer, announced in the House of Commons that the public will hereafter know the state of the Account every six months, three months in arrears. On March 30, 1937, the Account held 26,674,000 fine ounces of gold, the Issue Department of the Bank of England having

1. Further discussion of the operations of the Account will be found in the next section.

73,842,000 ounces, representing over £ 700 m. in the aggregate. The Account did not hold more than a trifling amount of foreign money.

Let us now proceed to discuss what effect the operations of the Account have on the London money market. Suppose that, due to an influx of foreign funds into the market, sterling has a tendency to appreciate. The Account wants to keep down sterling by buying gold. In order to do this, it borrows by means of Treasury bills, thus withdrawing money from the money market; there is a transfer of money from the deposits of the joint stock banks with the Bank of England to the public deposits. Since the reserves of the banks are reduced, they are compelled to reduce their demand liabilities by several times the amount of the reduction in reserves. They bring about this adjustment between their liabilities and reserves by calling in loans; since every loan creates a deposit liability, a reduction in loans means a reduction in liabilities. The flotation of Treasury bills by the Account thus leads to a stringency in the money market. This stringency, however, is soon relieved when the Account buys gold to keep down sterling. The purchase of gold naturally involves a transfer of money from the public deposits to the deposits of the joint stock banks with the Bank of England. The banks are, therefore, in a position to restore their deposit liabilities to the former level. This they do by expanding their loans. The money that was withdrawn from the market by means of Treasury

bills is thus restored to it through the purchase of gold.

The withdrawal of foreign funds also temporarily creates a stringency. It should be noted that a mere withdrawal of foreign funds need not make much difference to the money market if it is allowed to have its effect on the rate of exchange. The rate of exchange will fall to a level at which the sterling balances offered by some will be attractive for others to buy. Thus, there will be only a transfer of ownership within the market without making any difference to the money market as a whole. Sometimes such a withdrawal may result in a transfer of funds from the clearing banks to the agents of foreign banks in London. A temporary stringency may, however, arise as a result of the withdrawal of foreign funds if the Account intervenes to prevent a fall in sterling. When the Account sells gold to support sterling, it brings about a transfer of funds from the reserves of the joint stock banks to the public deposits. There is thus a stringency which is not removed till the extra funds in the public deposits are utilised for the repurchase or redemption of Treasury bills. When this happens, the reserves and deposits of the joint stock banks are restored to their former level. There is usually a timelag between the two sets of transactions: the purchase or sale of gold and the issue or repayment of Treasury bills. The amount of Treasury Bills issued does not normally vary

from one Friday to another by more than £ 5 m. If, therefore, the Account has withdrawn or returned several millions of pounds by a big sale or purchase of gold, it will take a number of weeks before its effect on the money market is fully offset by changes in the issue of Treasury bills.

It will be noticed that, other thing being equal, so long as every official transaction by way of sale or purchase of gold is offset by a corresponding change in the issue of Treasury bills, there need not be any change in the cash reserves of the joint stock banks with the Bank of England, while at the same time, the stability of the rate of exchange is assured as a result of the sale or purchase of gold. Indeed, this is the peculiar characteristic of the new monetary technique. It combines the stability of exchanges, which is the essential feature of the gold standard, with that freedom of bank reserves from the effects of external financial developments which is believed to be the main advantage of an independent monetary system. Under the gold standard, any influx of funds which pushes the exchange rate to the gold import point, brings about an inflow of gold which swells the cash reserves of the joint stock banks. If, when the funds are withdrawn, the state of the balance of payments is such that the exchange falls to the gold export point, gold flows out and the cash reserves of banks are correspondingly reduced. Under an unregulated paper standard, these unwanted increases and

reductions in the cash reserves of banks are eliminated, but only at the expense of violent fluctuations in the rate of exchange. The peculiar technique of exchange equalisation avoids both the evils and is of special advantage in these days when the movements of short-term funds between one centre and another have become extremely erratic in nature. The interests of exchange stability as well as those of domestic stability are thus fairly well assured.

Apart from its use in offsetting the movements of short-term funds, the Exchange Equalisation Account also provides a method by which the increasing supplies of gold are gradually absorbed into the monetary system without bringing about an unwanted expansion of currency and credit. We may even call this a method of sterilising gold.

This analysis of the theoretical position leads us to two important questions as to the practical working of the Exchange Equalisation Account. Is the Account really able to offset completely the effects of gold movements on the internal credit situation? Are there any limits to its ability to do so?

In the first place, it is necessary to realise that the operations of the Account in offsetting an influx of foreign funds and the accompanying influx of gold, by increasing the issue of Treasury bills, may not merely prevent an expansion of credit, but may even go further and actually bring about a contraction. It happens thus. In the normal course, the funds that

are withdrawn from the market by means of Treasury Bills are expected to be returned to it when the Account purchases gold to facilitate the transfer of foreign capital. The funds, however, do not come back to the market, even after the purchase of gold, if their owners hold them in the form of British currency; and in that case the stringency that is previously created by the issue of Treasury Bills persists. This is what actually happened on more than one occasions, when owing to the budgetary crises in France, French funds were brought to London merely to convert them into sterling notes. There was an increase in note circulation, which was accompanied by a decrease in the notes held in the Banking Department and also a reduction in bankers' deposits. The increase in the note circulation was only partially offset by an addition to the gold held by the Issue Department.

It follows, then, that in conducting its operations the Account has also to take into consideration the use to which the foreign funds are put. If they are hoarded in the form of British currency, the Account must provide for the necessary expansion in the note circulation by selling an equivalent amount of gold to the Issue Department and purchase a portion of its Treasury Bills out of the proceeds.

When, on the other hand, the foreign funds are left on deposit with the joint stock banks, instead of being hoarded in the form of notes, the stringency is considerably relieved, but is not completely removed.

It has been remarked time and again by practical financiers and journals devoted to practical finance like the *Economist* and the *Statist* that the influx of foreign funds into the banking system causes a stringency. On the face of it, the statement appears highly paradoxical. Let us try to understand this phenomenon by the help of elementary economic principles. The banks come into possession of the cheques issued by the Account in exchange for gold and are thus able to restore their cash reserve with the Bank of England to the former level. On the basis of this cash reserve, the banks can create a volume of credit which is only as big as that which existed before the Account withdrew money by means of Treasury Bills. But out of this volume of credit, the money market has to carry the Treasury Bills which are still outstanding and which correspond to the gold held by the Account. The amount of money left in the market, therefore, for financing other bills is now smaller than what it was before the Treasury Bills were floated. To that extent there is a slight stringency. The banks will be approached for discounting Treasury Bills and as soon as they do it, their deposits will increase and their cash reserves being unchanged, their cash ratios will be strained. The banks will not allow this to happen, with the result that the stringency will persist.

The appearance of this stringency, in spite of the restoration of bank deposits to their former level, is directly due to the fact that the foreign

deposits are held idle with the banks. If they are as active as the deposits which they replace, the stringency will not occur. If, for example, they are utilised for purchasing commodities or shares, there will be no strain on the banks. The purchase of commodities or shares would in effect amount to an increase in trade balance. It would then appear that the velocity of bank deposits has increased; the same volume of deposits has served to purchase the Treasury Bills and also to finance the normal volume of business transactions which it used to finance before the Treasury bills were floated. Thus, the supply of money has increased simultaneously with an increase in the demand for it and the rate of interest, therefore, remains unchanged. When, on the other hand, the deposits are held idle, there is no increase in the velocity and therefore in the supply of money, while the demand for money has increased, because the discount houses in London have to carry a much larger volume of bills than before. The result is a rise in the value of money, which is just another name for stringency.

There is an alternative, perhaps a more modern, way of looking at the matter. The demand for money may be conceived as the demand for idle cash or deposits. This is what Mr. Keynes calls the "liquidity preference." The liquidity preference, normally, remains unchanged, so long as the total income is unchanged. The mere issue of Treasury Bills, therefore, (when, presumably, there is no change

in the income of the community,) makes no difference to this liquidity preference. The demand for deposits remains unchanged. But the issue of Treasury bills involves a reduction in the supply of deposits and hence, there is a stringency and a rise in the rate of interest. When the proceeds of Treasury bills are used for the purchase of gold, the supply of deposits is restored to the former level, but in the meanwhile, there is an increase in the demand for deposits. The foreigners who come in possession of funds do not like to invest them in commodities or shares and thus, their demand for deposits competes with the community's demand and there is a rise in the rate of interest. If, however, the foreign funds are invested in commodities or shares, there is no increase in the demand for deposits (except such as may occur due to a possible rise in income resulting from increased purchases of goods) and the supply of deposits having been restored to the former size, the rate of interest recedes back very nearly to its original level.

It is hardly necessary here to remind ourselves that the banks create deposits by discounts and advances. If, therefore, they are asked to create additional deposits by increasing their discounts and advances at any given time,¹ it means that there is an increase in the demand for money in the sense that the volume of transactions has increased and there is

1. As, for example, happens when the banks are approached for discounting Treasury Bills in order to relieve the stringency resulting from an influx of foreign funds.

no compensatory increase in the velocity of circulation of existing deposits, or that the volume of transactions remaining unchanged, the supply of money has fallen due to a fall in the velocity of circulation of existing deposits, or what is just an alternative way of expressing the former of these two phenomena, the demand for money in the sense of a demand for liquid cash has increased due to a rise in the community's income, the liquidity preference remaining unchanged or an increase in the liquidity preference itself. The influx of foreign money may be conceived as an addition to the community's income which leads to a rise in the demand for deposits.

The stringency can be avoided by enabling the banks to expand their credit by an amount equal to the amount of foreign deposits which are held idle with them.¹ On the assumption that the banks keep a ratio of one to ten between their cash and deposit liabilities, they will be able to expand their deposit liabilities by the amount of foreign deposits, only if the Account sells to the Bank of England gold equal to at least one-tenth of the amount. It must be remembered that the reasoning in the last few paragraphs is based on the assumption that the foreign funds are left on deposit with the banks. If they are hoarded in the form of British currency, the whole of the gold purchased by the Account must be transferred to the Bank of England, if there is to be no stringency in the money market.

1. This suggestion was originally made by the *Economist*.

Actually, the Account has sold gold from time to time to the Bank of England. If we view the operations of the Account over a fairly long period, it would appear that the Account has not attempted to offset the inflow of foreign funds completely. A part of the gold acquired by it as a result of this inflow has been allowed to expand the credit base of the country.

It is worth noting that every sale of gold by the Account to the Bank of England involves a loss for the Account. Because, while the Account purchases gold at the current market price of, say 140 s. per fine ounce, the Bank buys it at its official buying price of 85s. per fine ounce. The losses resulting from these sales are debited to the Account, on the understanding that when the Bank's stock will be revalued, the Account will be reimbursed for these losses out of the profits arising from the revaluation. In the meanwhile, every sale of gold from the Account to the Bank diminishes the borrowing capacity of the Account, because more and more of it is used up in these losses.¹

It may be convenient at this stage to take a hurried glance at the working of the Exchange Funds in other important countries, before we proceed to a

1. However, in the last budget speech, Mr. Neville Chamberlain, the then Chancellor of the Exchequer, declared that the Account "still shows a profit." Probably, he based his calculations on the profit which is expected to arise in future from a revaluation of the gold reserve.

further study of the operations of the British Exchange Equalisation Account.

The Stabilisation Fund of the United States was established soon after the passing of the Gold Reserve Act of January 31, 1934. The Fund was supplied with resources, amounting to \$ 2,000 m. out of the profits arising from the revaluation of the gold reserve.

In more than one respect the operations of this Fund stand in a remarkable contrast with those of the British Exchange Equalisation Account. In the first place, the gold purchased by the Stabilisation Fund is added to the monetary stock of the country which is announced from time to time, while in England, it was only recently that the practice of announcing the gold holdings of the Account was started. Secondly, till the 21st December 1936, the gold purchases of the American Fund led simultaneously to an increase in the cash reserves of the banks; while in England, such purchases were neutralised in their effect on the cash reserves, which were increased only gradually by deliberate action, and sometimes such purchases even caused a stringency in the money market. The monetary gold stock of the United States increased from \$ 7,438 m. on February 7, 1934 to \$ 11,258 m. at the end of December 1936 i. e. by \$ 3,820 m. During the same period the member bank balances with the Reserve banks, increased from \$ 2,736 m. to \$ 6,606 m. i. e. by 3,870 m. The increase in the member bank

balances was more or less equal to the addition to the monetary stock of gold. Thus, the operations of the American Treasury were not at all directed towards preventing an influx of gold from expanding the credit base; their principal aim was only to prevent an appreciation of the dollar by selling dollars against gold. Perhaps, the American monetary authorities welcomed the creation of excess reserves in order to stimulate an expansion of credit. As early as the 5th January 1933, the Federal Reserve Board had declared that their policy would be to maintain a substantial amount of excess reserves.¹

In July 1936, when the excess reserves of the member banks reached the colossal figure of \$3,029 m. (which, if fully utilised, would have very nearly doubled the aggregate total of demand and time deposits of member banks on that date), the monetary authorities in the U. S. began to perceive the danger involved in the situation. They, however, chose for a time not to take any action to stop the creation of excess reserves altogether. They instead, reduced the volume of existing reserves by raising the reserve requirements of member banks by 50 per cent on August 15, 1936. The Federal Reserve Board was authorised to revise the reserve requirements by the Banking Act of 1935, provided it did not raise them to more than double the ratio laid down in the Federal Reserve Act. This

1. *Federal Reserve Bulletin*, January 1933, p. 2.

action was intended not merely to reduce the volume of excess reserves, but also to diminish the volume of additional credit that could be raised if the remaining excess reserves were utilised. The excess reserves were reduced from the level of \$ 3,029 m. in July to \$ 1,950 m. in August, but as the Treasury made no change in its method of financing the gold purchases, they went on increasing so that on the 30th November, 1936, they stood again at the menacing figure of \$ 2,236 m.

On the 21st December 1936, the American Treasury decided to follow the British method of neutralising the effect of gold purchases on member bank reserves. The Secretary of the Treasury announced, "the Treasury proposes to take appropriate action with respect to net additional acquisitions or releases of gold by the Treasury Department. This will be accomplished by the sale of additional public debt obligations, the proceeds of which will be used for the purchase of gold, and by the purchase or redemption of outstanding obligations in the case of movements in the reverse direction." In accordance with this policy, the Treasury has financed its purchases of gold since December 1936 by borrowing in the open market. In the following month, the Federal Reserve Board announced a further increase of $33\frac{1}{3}$ per cent in the reserve requirements of member banks; one half of it was to become effective on March 1, 1937 and the remaining half on May 1. As a result of this increase,

\$ 1,500 m. of excess reserves were eliminated, leaving the member banks with only \$ 500 m., which was considered to be a sufficient margin to finance further recovery and to maintain easy money conditions.¹

In the beginning of the current year, the total volume of deposits in American banks and the Postal Savings system, plus currency outside the banks, amounted to a figure which was \$ 2,000 m. larger than in the summer of 1929. According to the Federal Reserve Bulletin of February 1937, "the present volume of deposits, if utilised at a rate of turnover compared with the pre-depression level, is sufficient to sustain a vastly greater rate of business activity than exists today." If so, the credit situation in America is full of inflationary possibilities, and if the monetary authorities there insist on accumulating gold at the present rate, there is no choice left to them but to borrow on an ever increasing scale and on a rising money market in order to sterilise the inflow of gold, or to allow a limitless rise in cash reserves which may one day generate a credit boom, and thus ruin the little recovery that the country has been able to obtain at a heavy cost after the collapse of 1933.

It is interesting to observe another point of contrast between the credit situation in America and England. The one important reason why the excess reserves in America have still been incapable of generating an inflation, is that the velocity of

1. *Federal Reserve Bulletin*, January, 1937, pp. 2-6.

circulation of bank deposits is still very low in that country. While in England, the turnover of deposits has kept pace with the rising tide of recovery, in America it is still at the low level reached at the bottom of the depression.¹ The increase in deposits has not been accompanied by a corresponding increase in loans. The new deposits have been brought into existence entirely by the purchase of Government securities by the banks—securities which were created to finance the budgetary deficits. Thus, until recently, the Government helped to create additional reserves by its gold purchases, and the additional credit which the banks could raise on these reserves was also demanded by the Government to finance its budgetary deficit.² Both the supply and demand came from the same source.

The Exchange Equalisation Fund of Belgium came into existence after the devaluation of the belga in March 1935. Like the American Stabilisation Fund, the resources required for the Belgian Fund also were found out of the profits arising from the revaluation of the gold reserve. Although the belga was actually devaluated to the extent of 28 per cent, still the gold stock was revalued on the basis of a devaluation of 25 per cent, and out of the profits, 1,125 million belgian francs were set aside for the fund. The belga,

1. *The Economist*, 6-3-37, p. 530.

2. As the *Economist* truly observes, in America, the banks finance Government and Government finances industry. It is still peculiarly depression finance.

however, was free from serious disturbances after the devaluation and its value was maintained without any special intervention on the part of the fund. Due to repatriation of capital and an inflow of gold its value was fairly firm on the exchanges. The National Bank was always prepared to buy and sell gold at the gold points calculated on the basis of the new parity. For a whole year the exchanges were found to be remarkably stable at the new level. The Government, therefore, decided on April 1, 1936 to make the devaluation of 28 per cent definitive and the gold stock was revalued on this basis. The Exchange Equalisation Fund was wound up and its assets as well as those realised by the revaluation of the gold stock on the basis of the new parity were taken over by the Treasury. The belga was not materially disturbed in its exchange value by the European currency developments in the autumn of 1936.

The French "Fond de Stabilisation" was established by the monetary law of October 1, 1936. The profit on the revaluation of the gold reserve of the Bank of France amounted to 17,000 million francs; of which 10,000 m. francs were assigned to the Fund, and 7,000 m. were used for repaying the advances taken by the Treasury from the Bank of France. For a few days after devaluation, the franc had a tendency to appreciate as a result of a repatriation of capital and a return of gold. Being unduly optimistic about the future of the franc.

therefore, the French fund transferred 7 milliards to the Bank of France in October. The strength of the franc, however, proved to be short-lived and in November the currency began to decline due to speculative selling. The policy of the French fund from December onwards to keep the franc rigidly pegged at 105.15 was one of the factors that encouraged speculation during the period. The Fund had to part with large amounts of gold and foreign exchange for supporting the franc. When the London credit which was contracted in February 1936 fell due for repayment, the fund was found to be denuded of its gold and foreign exchange resources and the Bank of France had to retransfer 4 milliards of gold to it. Another 3 milliards were transferred in January 1937, to enable the Fund to combat the continued pressure on the franc. The French Government also concluded a credit of £ 40 m. with a syndicate of London banks in the same month.

In March, the French Fund abandoned the practice of rigidly fixing the exchange rate, and allowed the franc to move within a wide range. The sterling-franc rate immediately fell to 107. On March 8, a Committee of four neutral experts was appointed to take charge of the Stabilisation Fund.

There is one important difference between the method of operation of the French Fund and that of the British Fund. While the latter is always able to finance its purchases of gold by means of Treasury Bills, the former has had to rely mostly on

advances from the Bank of France. Due to the recurring budgetary deficits, the floating debt of the French Government has already reached an enormous figure and the banks have already invested in it probably the maximum proportion of their resources that they consider it safe to invest in this type of security. The scope for any further increase in the floating debt is, therefore, distinctly limited and the French Fund has necessarily to finance its purchases of gold by taking advances from the Bank of France. The point, perhaps, is only of an academic interest at present. If the French Fund had been continuously receiving gold like the British Fund, then perhaps it was an advantage to be able to pay for the purchases of gold by floating Treasury bills rather than by borrowing from the central bank and thus prevent an unwanted expansion of credit. But the French Fund received gold only in two short intervals since devaluation—in October 1936 and March 1937. For the rest of the period it has been losing gold. It has not had an opportunity so far of accumulating a sufficient gold reserve of its own to meet withdrawals. No technique of exchange management would avail under these circumstances to keep the exchange rate stable and still to keep the money market free from stringency in face of persistent withdrawals.

In the autumn of 1936 two more Exchange Funds came into existence, one in Switzerland and the other in the Netherlands. Although the Swiss franc was devaluated to the extent of 30 per cent, the gold

stock was revalued on the basis of a devaluation of 24.944 per cent and the surplus resulting from the revaluation was transferred to a special gold settlement account, under the Federal Council's instructions to the National Bank on September, 27 1936. The gold reserve amounted to 1,537 m. Swiss francs on the 26th September and its revaluation yielded a surplus of 538 million Swiss francs. Unlike the French Fund, both the National Bank of Switzerland and the Exchange Fund, were prepared to buy gold at the market price, as a result of which a considerable amount of gold came out of hoards. The gold purchases of the National Bank and the Exchange Fund brought about an abundance of funds in the money market. As regards the Exchange Equalisation Fund of the Netherlands, it closely follows the example of the British Fund in its method of operation. The gold stock of the Netherlands Bank like that of the Bank of England, is still valued at the old rate and hence the resources required by the Fund had to be provided by the Government. The gold purchased by the Fund is held outside the banking system and a part of it is sold to the Netherlands Bank as and when necessary. In last December, gold worth about 150 million guilders was sold by the Fund to the Bank. The Fund has maintained the guilder at a rate of depreciation equal to 20 per cent, and purchases all gold and foreign currency offered at that price. Except for a short while after the devaluation of the guilder, the Fund has

experienced little difficulty in maintaining the exchange rate.

In the summer of 1935, an Exchange Fund was instituted in the Dominion of Canada. There was no official devaluation of the Canadian dollar, but the gold stock of the country was revalued at the current market price of gold, namely, \$ 35 per fine ounce and the increment resulting from the revaluation, \$ 63 millions, was assigned to the Exchange Fund. The Fund bought Dominion bonds from the Bank of Canada and it also holds short-term Treasury Bills and funds on deposit at the Bank. Any profits or losses arising in future on the gold stock of the Bank from a change in the price of gold are to be credited or debited to the account of the Fund.

Thus, the technique of exchange equalisation has taken different shapes in different countries to suit their individual needs and circumstances. It is still in an experimental stage and its operation, especially in its relation to the internal credit situation, is so far only imperfectly understood. In the next Section, we will try to get a fuller appreciation of the working of the British Account, which is perhaps the most successful of all these experiments from the point of view of credit management.

II

THE GOLD PURCHASES OF THE BANK OF ENGLAND

BETWEEN December 31, 1931 and March 31, 1937, the gold stock of the Bank of England increased by £ 193 millions; of this amount, nearly £ 188 m. has been acquired in three or four sporadic waves of accumulation: £ 18.6 m. between March and September 1932, £ 69.6 m. between January and June 1933, (against this, we have to set £ 19.6 m. paid in December 1932 to the U.S.), £ 6.5 m. between September to December 1935 and £ 113.1 m. between March 1936 to March 1937. Of the last amount, £48.1 m. was acquired in six months between March to September 1936, and £ 65 m. was added on a single day, December 15, 1936! From June 1933 to September 1936, i. e. over a long period of nearly two and a quarter years, the Bank of England increased its gold stock by less than five millions. This highly sporadic nature of the gold acquisition process of the Bank of England stands in a remarkable contrast with the more or less continuous increase in the central reserves of the banking system in the United States. The contrast is due as much to the difference of methods as to the divergence of aims. While in England the newly purchased gold was held outside the monetary system, in America, although the new gold was held in the Treasury, the Federal Reserve banks got a credit for it in their gold certificate account and thus there was an increase in their

reserves. It was a part of the deliberate policy of the Federal Reserve system to encourage the growth of reserves, while in England, the course of monetary expansion was controlled to a much larger extent.

Another interesting fact to be noted about the working of the British monetary system in the last six years is that on more than one occasion, the increase in the gold stock was accompanied by an increase in the note circulation, or an increase in the gold cover of the note issue and thus a credit expansion was restricted. Since the operations of the Account are kept extremely secret, it is difficult to say whether the transfer of gold to the Bank was arranged to provide for the expansion in circulation or it was only a matter of coincidence. A mere sale of gold from the Account to the Bank does not guarantee credit expansion, unless it is known that the Bank does not offset it by applying for a reduction in the fiduciary issue or by selling securities held in the Banking Department. An analysis of the Bank of England's returns shows that even if the Bank does not take any such step, an increase in the note circulation may operate to restrict the credit expansion. An increase in the demand for currency may be due to an increase in hoarding or to an increase in cash payments caused by an improvement in business activity. It first affects the tills of the joint stock banks which consequently draw upon their reserves with the Bank of England. In this way the reserves of the joint stock banks are reduced and

SUMMARY OF BANK OF ENGLAND RETURNS

(in millions of pounds sterling)

Date	Gold in Issue Dept.	Notes in Banking Dept.	Discounts & advances	Securities	Note Circulation	Bankers' Deposits	Public Deposits	Other Deposits
1931								
Oct. 28	135.7	54.6	10.5	84.6	356.0	63.5	17.3	52.6
Nov. 25	120.7	41.3	12.7	87.8	354.4	59.8	27.0	38.1
Dec. 30	120.7	31.6	27.3	133.0	364.2	126.4	7.7	40.3
1932								
Mar. 30	120.8	35.3	11.7	86.8	360.5	54.6	27.2	34.4
June 29	136.1	48.1	14.9	93.5	363.1	86.6	18.0	34.7
Sept. 28	139.4	54.6	12.1	88.0	359.8	80.6	23.4	33.4
Nov. 30	139.4	55.6	11.9	87.1	358.8	90.5	10.1	37.1
Dec. 28	119.8	23.6	18.5	120.1	371.2	102.4	8.9	33.8
1933								
Mar. 29	171.8	79.7	11.8	74.9	367.1	92.8	21.2	35.0
June 28	189.4	74.2	16.6	87.2	375.1	105.1	14.1	42.2
Sept. 27	190.4	79.6	9.2	85.8	370.8	97.3	16.5	44.0
Nov. 29	190.6	80.4	8.6	84.7	370.2	106.9	13.6	36.5
Dec. 27	190.7	58.7	16.8	101.4	392.0	101.2	22.2	36.5
1934								
Mar. 28	101.1	72.3	5.6	88.1	378.8	94.5	17.5	36.9
June 27	191.5	69.8	6.1	91.9	381.7	96.3	17.6	36.5
Sept. 26	191.9	74.9	7.2	92.2	377.0	83.0	37.9	36.8
Nov. 28	192.1	72.4	9.2	90.6	379.7	89.1	27.7	38.1
Dec. 26	192.3	47.1	7.6	98.2	405.2	89.1	9.9	36.4

SUMMARY OF BANK OF ENGLAND RETURNS

(in millions of pounds sterling)

(Contd.)

Date	Gold in Issue Dept.	Notes in Banking Dept.	Discounts & advances	Securi- ties	Note Circula- tion	Bankers' Deposits	Public Deposits	Other Deposits
1935								
Mar. 27	192.5	71.1	5.6	99.0	381.4	96.6	20.1	41.2
June 26	192.7	55.9	10.2	108.6	396.9	102.4	16.2	38.8
Sept. 25	193.6	55.4	12.4	95.4	398.2	87.2	19.5	39.0
Nov. 27	197.6	56.3	9.5	98.4	401.3	90.9	19.7	36.5
Dec. 25	200.1	35.5	8.5	94.7	424.5	72.1	12.1	37.1
1936								
Mar. 25	200.6	54.1	5.0	97.0	406.5	83.6	18.0	37.1
June 24	216.3	41.5	7.6	116.1	434.8	90.8	20.0	37.4
Sept. 30	248.7	59.3	8.6	100.7	449.4	67.7	49.7	40.9
Nov. 25	248.7	63.1	6.8	98.6	445.6	97.6	12.1	41.7
Dec. 30	313.7	46.3	17.5	155.6	467.4	150.6	12.1	39.2
1937								
Mar. 31	313.7	39.8	7.1	123.4	473.8	62.3	52.2	38.5
June 30	326.4	38.0	6.3	164.3	488.4	140.5	10.8	40.1

LONDON CLEARING BANKS

(Figures in millions of pounds for 10 Banks)

Date	Cash	Bills discounted	Securities	Loans	Total Deposits
1931					
March	184	240	311	939	1,764
June	187	266	288	926	1,782
September	174	237	304	915	1,712
November	173	241	300	904	1,706
December	184	246	297	905	1,737
1932					
March	174	217	282	906	1,676
June	191	278	340	856	1,764
September	193	392	383	806	1,865
November	193	381	425	789	1,898
December	207	408	472	778	1,983
1933					
March	207	348	510	769	1,925
June	213	352	544	779	1,978
September	215	355	563	753	1,958
November	216	317	569	741	1,928
December	213	311	565	740	1,941
1934					
March	219	202	547	757	1,831
June	199	228	549	761	1,870
September	207	213	563	757	1,858
November	210	233	589	759	1,911
December	216	255	594	759	2,222
1935					
March	214	207	614	771	1,923
June	217	244	624	780	2,004
September	208	299	619	766	2,024
November	214	293	621	778	2,040
December	221	322	605	784	2,091

LONDON CLEARING BANKS

(Figures in millions of pounds for 10 Banks)

(Contd.)

Date	Cash	Bills discounted	Securities	Loans	Total Deposits
1936					
March	210	249	605	829	2,038
June	218	322	612	852	2,155
September	222	336	620	854	2,180
November	225	322	626	868	2,210
December	236	316	630	864	2,233
1936 (11 Clearing Banks)					
March	217	252	635	854	2,108
June	225	329	642	873	2,229
September	229	344	648	882	2,257
November	233	329	656	895	2,287
December	244	322	660	890	2,315
1937 (11 Clearing Banks)					
March	226	248	667	939	2,244
June	241	259	654	963	2,293

the volume of credit based upon these reserves suffers a severe restriction. If the Account, under these circumstances, sells gold to the Bank, the situation is corrected. The Account sells gold to the Issue Department and receives notes in exchange for it which are deposited for credit of public deposits with the Banking Department. There is simultaneously an increase in public deposits on the liabilities side of the Banking Department and an increase in the reserve of notes on the assets side. The increase in public deposits is afterwards transferred to bankers' deposits and the stringency in the money market is relieved.

Here again the British monetary system offers an interesting point of contrast with the American monetary system. The increase in the demand for currency during the same period in America was mainly satisfied by an increase in silver certificates and in silver coin, leaving the additions to the gold stock free to exercise their full effect on the banking reserves. From February 1934 to the 31st December 1936 the gold stock of the U.S. increased from \$ 7, 438 m. to \$ 11,258 m., the reserve balances of the member banks from \$ 2,799 m. to 6,665 m. and the money in circulation from \$ 5,354 m. to 6,543 m. While the increase in the reserve balances (viz. \$ 3,866 m.) was almost equal to the increase in the gold stock (viz. \$ 3,820 m.), the increase in the monetary circulation was only \$ 1,189 of which \$ 658 m. was represented by an expansion in the

circulation of silver certificates. Thus, the effect of additions to the gold stock on the member bank reserves was in no way neutralised by changes in the monetary circulation.

In England, on the other hand, there are several hitches between a purchase of gold by the Exchange Equalisation Account and an expansion in the credit base of the country. In the first place, the new gold may simply be hoarded in the Account, the money required for its purchase being found by borrowing. Secondly, even when a part of it is sold to the Bank of England, the latter pays for it its official price of 85s. per oz. which is only 60 per cent of its market price. Thirdly, the Bank may pay for the gold it purchases by selling securities in the Issue Department and not by issuing new notes. Fourthly, even when new notes are issued, the Bank of England can offset their effect by reducing its other assets such as its discounts and advances or securities in the Banking Department. In that case, there will be no rise either in bankers' deposits with the Bank of England or the total cash reserves of the banks. Fifthly, although the Bank of England makes no such compensatory move, there is no guarantee that bankers' deposits will show an increase, because there is a time-lag between the transfer of money to public deposits and its retransfer to bankers' deposits and secondly, because there may simultaneously be an increase in the note circulation. To what extent the increase in the note circulation will serve to

expand the credit base, depends on how much of it actually finds its way into the vaults of the joint stock banks.

We will, therefore, tackle the problem in two parts; first by examining the effect of gold purchases on bankers' deposits, and secondly, by examining their effect on the total cash reserves of the banks and the total bank deposits. Briefly speaking, between 31st December 1931 and 31st March 1937 the gold held in the Issue Department increased by £ 193 m. Out of this, £ 75 m. was absorbed by reducing the fiduciary issue, so that no expansion of currency or credit took place as a result of the transfer. The remaining £ 118 m. increased the total note issue by an equivalent amount (from £ 395 m. to £ 513 m.), but there was no increase in bankers' deposits between the two dates, because among other changes, the effect of the increase in the note issue was mainly offset by an increase of £ 109 m. in the note circulation. No doubt the whole of this addition to the note circulation cannot remain outside the banking system; some portion of it must have found its way into the cash reserves of the joint stock banks and become the basis of additional credit, although the proportion cannot be the same from time to time. It is believed ¹ that about 20 per cent of an increase in the note circulation normally finds its way into the tills of the joint stock banks. We

1. *The Economist* (dated 6-6-36, p.555) has mentioned this fact in a different connection.

will revert to this point later, but in the meanwhile we can safely conclude that in England the new money which is created by gold purchase transactions has to percolate through many sieves and the proportion of it which finally goes to strengthen the credit base of the country is very small, indeed.

Let us take the above mentioned periods of gold acquisition by the Bank of England one by one and consider first how the gold purchases of the Bank have affected bankers' deposits.¹ From March 30 to September 23, 1932, the Bank added £ 18.6 m. to its gold stock. During the same period, the note circulation decreased from £ 360.5 m. to £ 359.8 m. i.e. by £ 700,000. The securities in the Banking Department increased by £ 1.2 m. and public deposits decreased by £ 3.8 m. As a combined result of all these factors, bankers' deposits increased by £ 26 m. and the notes in the banking Department increased by a little more than the addition to the total note issue, i.e. by £ 19.3 m. So far as this period is concerned, we can rightly say that the gold purchase operations of the Exchange Equalisation account and the simultaneous purchase of gold by the Bank of England did really expand the credit base of the country. In fact, the expansion was deliberately brought about by the authorities in order to facilitate the Conversion operations.

In the following period, from January to June 1933, the gold holdings of the Bank of England

1. See Table on pages 127-28

increased by £ 69.6 m., but about 60 per cent of it, (i.e. £ 48 m.) was offset by a reduction of £ 32.9 m. in the security holdings of the Banking Department and by a reduction of £ 15 m. in the fiduciary issue (i.e. in the security holdings of the Issue Department) which took effect on April 1, 1933. There was also an increase in the note circulation to the extent of £ 4 m. and in public deposits to the extent of £ 5 m. Bankers' deposits increased only by £ 3 m. An addition of nearly £ 70 m. worth of gold in a short period of six months was, indeed, an important change and we must remember that it was the biggest addition to the gold reserve of the Bank of England that took place in the entire period from December 1931 to March 1936; still it was absorbed in the monetary system in such a way as not to permit more than a reasonable increase in bankers' deposits.

The next increase in the gold reserve was of a small magnitude, of £ 6.5 m.; it took place between September and December 1935. This was a period when both France and the Netherlands were afflicted by an acute internal crisis and there was a large scale hoarding of notes by foreigners. The note circulation jumped from £ 398.2 m. to £ 424.5 m. i.e. by £ 26.3 m. There was a slight decrease in security holdings and the only compensatory change was a decrease of £ 7.4 m. in public deposits. Under these circumstances, the transfer of only £ 6.5 m. of gold from the Account to the Bank proved to be

extremely inadequate and bankers' deposits fell by £15 m. Probably the Bank expected the expansion in the note circulation to be short-lived, being caused partly by seasonal factors and partly by abnormal events abroad and did not consider it necessary to offset it completely by a sufficient addition to its gold stock. In the next month, January 1936, the note circulation fell by £18 m.

The period, March 1936 to March 1937, was a period of rapid acquisition of gold by the Bank of England. The Bank increased its holdings by more than £113 m. during this period. Even this huge quantity of gold was absorbed into the system without an undue expansion of credit. As said above, the Bank acquired £48 m. over six months, from March to September, and £65 m. on a single day, 15th December 1936. The purchase of £48 m. was necessitated by the steep rise of £43 m. in the note circulation from March to September. There was a small rise of £3.7 m. in the security holdings, and £3.6 m. in discounts and advances. But at the same time public deposits increased by £32 m., thus reaching the record level of nearly £50 m., since October 1931. As a combined effect of these changes, bankers' deposits fell by £23 m. After the period January to June 1933, during which the gold stock of the Bank showed a rise of £69.6 m., the increase of £48 m. in March to September 1936 was the next big increase, and like its predecessor, this was also drawn into the monetary system in such a way that

the credit base of the country remained within the desired limits.

The purchase of £ 65 m. of gold on the 15th December 1936 was intended more for relieving the Exchange Equalisation Account whose sterling resources were being rapidly exhausted owing to a persistent inflow of gold, than for any material expansion of credit. It was accordingly accompanied by a reduction in the fiduciary issue to the extent of £ 60 m., allowing a net addition of only £ 5 millions to the note issue. There were, however, other changes in the Bank of England's operations which were tending to bring about an expansion of the credit base. The security holdings in the Banking Department were up by £ 55.6 m., reaching the figure of 155.6 m. which was the highest reached since October 1931, the discounts and advances by £ 10.7 m., and public deposits had dropped down by £ 37.6 m., from their peak level in the previous September. These changes, combined with the increase of £ 5 m. in the note issue involved in the gold purchase were sufficient to counteract the restrictive effect of an expansion of £ 18 m. in the note circulation and bankers' deposits improved by £ 90 m. from the rock bottom level of £ 60 m. to which they had dropped in the previous autumn. It must be emphasised here, however, that the recovery in bankers' deposits was not due to the gold purchase, except to the small extent of £ 5 m., but mainly to changes in items other than the gold holdings of the Bank.

Bankers' deposits did not remain at the high figure for a long time. In March 1937, all the items which had changed favourably in December 1936 took an adverse turn, although the gold holdings were constant. The security holdings were reduced, discounts and advances came down, the note circulation increased further and public deposits exceeded the high water mark reached in September 1936; with the result that bankers' deposits relapsed again to £ 62. 3 m.

It will be observed that the Bank of England has been helped by two important factors in minimising the effects of its gold absorption on the credit situation; one is the elasticity of the fiduciary issue and the other is the constant growth of the note circulation. Had it not been for these two factors, there would have been an inordinate expansion in the supply of credit. If the British authorities had followed the American practice, the whole of the increase of £ 193 millions in the gold stock of the Bank would have been reflected in the bankers' reserves thereby allowing an expansion of something like £ 1930 millions in the total bank deposits. It will be remembered that the note issue has increased by only £ 118 millions and the note circulation by £ 109 millions. Could it be that the whole of this increase in the note circulation has gone into the cash reserves of banks? By no means; because in that case the total bank deposits would have risen by £ 1090 millions and that also would have been a dangerous

state of inflation ! Actually, between December 1931 and September 1936, the total cash reserves of London clearing banks increased by £ 38 millions and their deposit liabilities by £443 millions. Between September and December 1936, both the cash reserves and the deposits increased further by £ 14 m. and £ 58 m. respectively, but the increase was only temporary and both were again reduced between December 1936 and March 1937 to a much lower level. Over the whole period, the total bank reserves have increased by about £42 m. and the total bank deposits by £ 500 m., which is certainly a very moderate and necessary increase. The increase in bank reserves represents only 22 per cent of the total value of gold purchased by the Bank of England at the official price during the period. The percentage would obviously be much smaller if we consider the total value of gold purchased by the Exchange Equalisation Account at the market price.

If we examine the returns of the English clearing banks for the period, we will find how carefully the process of credit expansion in England was controlled by the monetary authorities there. During the first stage in the gold acquisition process of the Bank of England (from March to September 1932) when the Bank wanted a plethora of funds in the money market, the total clearing bank reserves as well as bankers' deposits fully reflected the effect of its gold purchases. During the second stage, however, from January to June 1933 when the Bank of England purchased as

much as £ 70 m. worth of gold, bankers' deposits increased by only £ 3 m., the total clearing bank reserves by £ 6 m. and the total deposits only by a small amount. From June 1933 to March 1936, when the Bank's acquisition of gold was proceeding at a very slow rate, the bank reserves were being gradually strengthened and the bank deposits were rising by slow degrees. The really rapid and substantial increase in bank reserves and deposits took place between March and December 1936, when the industrial recovery in England gathered its real momentum. But even during this period, the increase in bank reserves (£ 26 m.) was not more than 23 per cent of the total amount of gold purchased by the Bank (£ 113 m.) or 50 per cent of the increase in the note issue (£ 53 m.). The new device of Exchange Equalisation Account has thus worked wonderfully well in helping the monetary authorities in England in the management of the internal credit situation.

From the statistics now available, it seems that the London gold market is entirely dominated by the operations of the Exchange Equalisation Account. Since the beginning of 1932 to the 31st March 1937, the Bank of England purchased gold worth £193 m. i. e. 45,411,000 oz. (converted at the official price). To this, we may add 26,674,000 oz. of gold that the Account held on March 31, 1937 in order to find the aggregate amount purchased by the British monetary authorities during the entire period. The total, 72,085,000 oz., amounts to 68 per cent of the net

import of gold into England, 105,620,000 oz., from the beginning of 1932 to March 31, 1937. From this we can get an idea of the extent to which the London gold market is dominated by the Account and also what serious repercussions any change in the policy of the Account may produce in that market.¹

It has never been the policy of the Account to counteract strong and persistent tendencies either towards appreciation or depreciation. Such tendencies are only moderated in their effect, so that the resulting rise or fall in sterling is more gradual than it would otherwise be. It is obvious that if the Account had followed a policy of keeping sterling rigidly fixed at one level, say for example in the period from April 1935 to September 1936, when there was a heavy flow of funds towards London, the Account would have been able to amass a much bigger stock of gold. The main reason why the flow of gold has been persistently in the direction of New York since 1934 is to be found in the fact that the policy of the American Treasury in this respect is just the reverse of that of the British Account. Ever since the 31st January 1934, the value of the dollar in terms of gold has been rigidly fixed in face of a strong movement of foreign capital towards the United States.

1. Since March 1937 the Bank of England has further increased its gold stock. In May last, for example, when the note circulation had reached a record figure, the Bank had to purchase gold from the Exchange Equalisation Account in order to provide for an addition to the note issue.

Let us, finally, briefly survey the trend of the sterling-dollar exchange since September 1931. On the suspension of the gold standard in that month, sterling came down from its par level of \$ 4.86 to \$ 3.80 and fell further to \$ 3.37 in December. The British monetary authorities had no means to prevent the depreciation of sterling at that time. During the first half of 1932, however, sterling gradually recovered to \$ 3.67 but after June, there was a setback due to various reasons which have been already explained elsewhere, and it came down to the low level of \$ 3.27 in December. The Account probably had to lose most of the gold it had acquired since its inception. Soon after December 1932, the tide turned, and throughout the year 1933, sterling was consistently strong, rising from \$ 3.35 in January to \$ 5.11 in December. The Account must have gained a considerable amount of gold during this year. 1934 was a year of relapse. Except for short intervals, the trend of sterling was mostly downward and it continued to be so till March 1935 when it was quoted at \$ 4.77 as compared to 5.11 in December 1933. From April 1935 to September 1935, i. e. from the Belgian to the French devaluation, sterling again became the favoured currency, its value rising from the low level of 4.77 in March 1935 to 5.03 in September 1936. The Account had another big opportunity of acquiring gold. After September, 1936 there was a slight recession due to the repatriation of Continental funds, but lately, London has again

begun to attract funds and the Account has to buy gold to prevent an undue appreciation of sterling. It would appear, therefore, that before 1937, the Account had only two really good opportunities of acquiring gold—one in the year 1933 and the other during the period between the Belgian and the French devaluations.

The operations of the Account in offsetting the capital movements of 1932 and 1933 and thus manipulating the external value of sterling have given rise to certain criticisms and it may be interesting to know the essential points involved in them. Mr. N. F. Hall's analysis¹ of the relevant facts and figures is extremely helpful for the purpose. In 1932 the authorities had planned to effect the conversion of the 5 per cent War Loan to a 3½ per cent basis and had accordingly decided to encourage low money rates in London. The money rates had already fallen, but apart from the open market operations of the Bank of England, one important factor in the fall in the money rates was the accumulation of foreign balances in London. The British monetary authorities were faced with a very difficult problem. While, on the one hand, they had to avoid any action that would have scared away the foreign balances, they had on the other hand to take the utmost care to prevent any further rise in sterling such as would have resulted from an uncontrolled influx of funds. Such rise in sterling as had taken

1. N. F. Hall : *The Exchange Equalisation Account* pp. 34-83.

place was already causing anxiety, because by May 1932 the British "gold" prices of primary products had come very near the level of the American prices. At the same time the discount on forward dollars was rising, so that the net gain that could be derived by transferring money to London and covering it by purchasing forward dollars was increasing. Thus, there was a real inducement for foreign balances to accumulate in London, thereby leading to a rise in sterling, while at the same time, the narrowing "spread" between the British gold and American prices indicated that any further rise in sterling would mean overvaluation. The low quotation for the forward rate of sterling showed that a good deal of the foreign balances in London were not covered by forward sales. The situation, therefore, was very delicate. There was a prospect of violent movements in sterling. Over this situation supervened the conversion operation. The War Loan was to be converted in December, 1932 so that in September, it became equivalent to a three months' sterling bill bearing interest at 5 per cent, which was a very attractive form of investment for foreign balances. Steps had to be taken to prevent the sales of this loan to foreigners, because such sales would have led to a steep rise in sterling in September followed by an equally precipitate fall in December. Hence a bonus was offered to those who would give notice of their intention to convert before the 31st July 1932. This bonus was of great help to the Account

in its efforts to minimise exchange disturbances. The Account succeeded in moderating the rise in sterling. It acquired considerable gold and sold it to the Bank of England, thereby helping it in its appointed task of promoting easy money conditions. In June and July the pound began to fall and to the great satisfaction of the British authorities, the spread between the British gold and American prices again widened and the discount on the forward dollar disappeared. The pound was steady in August, September and October 1932, at a rate of depreciation equal to 70 per cent of the former parity, probably because the authorities believed this to be the equilibrium rate. In the latter part of October, however, sterling broke sharply, due mainly to the uncertainty about the war debt question. The Account had no means to prevent the fall at that time. It had sold its gold to the Bank of England and a repurchase of it would have led to a reversal of the cheap money policy. The foreign currency acquired earlier in the year had been used for paying the Paris and New York credits incurred in August 1931. Mr. Hall remarks that had the Account aimed at a lower rate in July, August and September, probably it would have been able to acquire a sufficient ammunition to prevent the fall in sterling which occurred in October and November.

It is clear from the above analysis that there was ample justification for the Account to moderate the rise in sterling in the summer of 1932, while it was

beyond its power to prevent its fall in October of that year. It certainly does not appear to have been the object of the Account (at least in 1932) to keep down the value of sterling so as to increase the competitive power of British industry.

The American crisis of 1933 gave the Account a splendid opportunity of acquiring gold, which it fully utilised by controlling the rise in the value of sterling. Towards the end of 1932, the gold resources of London had been severely reduced and it was clearly essential for the monetary stability of the entire sterling area as well as of Great Britain that London should possess sufficient liquid resources to prevent a fall in sterling, such as had occurred in 1932. A rise in sterling at that time, moreover, would have had a deflationary effect on British prices. There was a strong flow of funds towards London, so much so that in addition to an acquisition of £ 70 m. by the Bank of England, London was also able to arrange a credit of £ 40 m. for France. These operations of the Account have been criticised on the ground that the Account could have acquired very nearly all the gold it wanted, even if it had aimed at a little higher level for the pound. Such a policy would have been helpful to the gold standard countries, although the troubles in America were too serious to be relieved by any such palliative. So long as the dollar was on gold, it had a great influence on the gold currencies; so that the operations of the Account in supporting the

dollar indirectly led to an overvaluation of the gold currencies and a further fall in gold prices. There was a great increase in hoarding in the next few months which hindered the acquisition of new gold by central banks and this development also could have been prevented to some extent if the British policy had been more liberal. It must, however, be said on behalf of the Account that although the losses of gold by the Continental countries in 1933 were aggravated by the purchases made by the Account, their central banks were still left with much higher reserves in December 1933 than they had in March 1931. The operations of the Account, therefore, led to a desirable shift in the distribution of gold. ¹

¹ Hall, *Op. cit.* p. 68,

THE STERLING-DOLLAR EXCHANGE

(Dollars per hundred pounds)

1931	Dec.	337.37	1934	Jan.	504.93	1936	Jan.	496.27
1932	Jan.	343.12		Feb.	503.26		Feb.	500.05
	Feb.	345.63		March	509.39		March	497.07
	March	363.93		April	515.34		April	494.27
	April	374.99		May	510.63		May	496.97
	May	367.51		June	504.84		June	501.92
	June	364.66		July	504.07		July	502.25
	July	354.96		Aug.	506.51		Aug.	502.59
	Aug.	347.57		Sept.	499.41		Sept.	503.63
	Sept.	347.11		Oct.	494.09		Oct.	489.84
	Oct.	339.62		Nov.	498.90		Nov.	488.80
	Nov.	327.53		Dec.	494.58		Dec.	490.78
	Dec.	327.79	1935	Jan.	489.24	1937	Jan.	490.75
1933	Jan.	336.14		Feb.	487.35		Feb.	489.39
	Feb.	342.21		March	477.62		March	488.51
	March	343.28		April	483.68		April	494.1
	April	357.93		May	488.77		May	493.8
	May	393.24		June	493.49		June	494.5
	June	413.56		July	495.76		July	497.2
	July	464.99		Aug.	426.99		Aug.	498.9
	Aug.	450.27		Sept.	493.06			
	Sept.	466.47		Oct.	490.78			
	Oct.	466.83		Nov.	492.49			
	Nov.	514.97		Dec.	492.88			
	Dec.	511.59						

THE STERLING-FRANC EXCHANGE

(Francs to a pound)

January	1927	122.68
"	1928	124.00
"	1929	124.10½
"	1930	123.91
"	1931	123.66½
"	1932	86.37½
"	1933	85.50
"	1934	83.00
"	1935	74.68½
"	1936	74.62½
September	"	76.59½
October	"	105.15½
March	1937	106.35
June	"	110.50
July	"	128.81
August	"	132.92

1. The following broad stages may be noted in the appreciation of the franc in terms of sterling: (1) 1932-34, when the sterling-franc rate fluctuated round a mean level of 83 or 84 as compared to the par value of 124.21. (2) from March 1935 to September 1936, when the mean level dropped down to 74 or 75 as compared to 84 of the previous period. Since the franc was on gold up to September 1936, these were also the main stages in the rise in the price of gold in terms of sterling. There were, similarly, three stages in the depreciation of the franc which ensued after devaluation. (1) From October 1936 to February 1937, when the franc was more or less rigidly held at the level of 105.15½. (2) From March to June 1937, when the franc was allowed to sag to 110. (3) The second devaluation of the franc in June to the level of 129.

CHAPTER V

THE FUTURE OF GOLD

LIKE King Midas, the world which was grumbling of a shortage of gold just a few years ago is now suffering from a surfeit of it. We have a prospect of an output of more than 40 million ounces in the next few years as compared with a bare 19.6 million of 1929; and besides, there is an export of 3 to 4 millions a year from India to be reckoned at least for some time. The problem before the world is how to absorb this flood of gold at its current market price, without bringing about a dangerous state of inflation. The industrial consumption has already come down from 3.5 million ounces in 1929 to nearly 1.7 million ounces today. The demand for gold for hoarding purposes is also on the wane. A rapid process of dishoarding of gold has begun and it is believed that a good deal of the gold which was offered in London in April and June last had come out of the private hoards which were transferred there during the last few years. The amount of privately hoarded gold which was estimated at 7,000 million Swiss francs or \$ 2,273 millions (at the new parity) at the end of 1934 is now put at \$ 1,000 millions. As conditions improve and the attractions of industrial investment increase, the tendency to hold money in a liquid form will gradually disappear and thus the one important factor

which has helped to sustain the demand for gold during the years of the trade depression will have been removed. As regards the monetary demand for gold, while some countries like England, U. S. and France have a stock of gold which is far in excess of their present or prospective needs, other countries like Germany are suffering from an acute shortage of it. Taken in the aggregate, however, the world's monetary gold stock is probably in excess of demand. Although the comparison is not quite scientific, it may be stated for what it is worth that while according to the forecast of the Gold Delegation,¹ an increment of \$ 363 millions was required in the gold reserves of the world in 1936 to enable the price level to be maintained at the 1928 level, the actual increment in that year was \$ 1,080 millions at the new parity.

We have already surveyed the various expedients tried in England, America and other countries to absorb the excess flow of gold in the monetary system without influencing the credit situation. By holding gold outside the banking system in Exchange Equalisation Accounts or by reducing the fiduciary issue or by raising the reserve requirements of member banks, the inflow of new gold is made innocuous so far as the

¹ First Interim Report of the Gold Delegation, p. 16. The Gold Delegation calculated that in 1935 the world would need central bank reserves amounting to \$ 11,289 m.; the actual reserves in 1935 were \$ 12,000 m., at the old parity or \$ 21,000 m. at the new parity.

supply of credit is concerned. It is questionable, however, how long the process can continue. At present the main responsibility for purchasing the new gold coming on the markets of the world and thus supporting the price of gold, is being shouldered by England and America. Both these countries are borrowing on a large scale to finance their purchase of gold. There is obviously a limit up to which England can reduce her fiduciary issue, the U. S. can increase the reserve requirements of her banks, and both England and the U. S. can allow the burden of their interest charges to grow by borrowing to hoard gold which yields no interest. Such an unproductive use of public resources can be justified only so long as the purchase of gold corresponds to an influx of "hot money." But there will soon come a time, with a progressive restoration of confidence in international banking centres, when even the amount of international hot money will be gradually reduced and its movements will cease to be erratic, while the supply of gold which is at present demanded as the medium of transferring the hot money, will continue to increase. The question is what is to happen then. The hope that France will resume her traditional role of a large purchaser of gold on the world market after being freed from her financial troubles, has not yet been realised. Are England and America, then, to continue to buy gold without limit or are they to revise their respective policies so as to bring the price of gold more in alignment with

the changed relation between its demand and supply?

There is almost a consensus of opinion among economists,¹ that any step to reduce the price of gold or to restrict its purchases will be fraught with grave deflationary consequences. It will give a rude shock to business confidence and will immediately arrest the pace of recovery. The gold scares of April and June last are adduced as instances to show what serious repercussions may be produced in the security and commodity markets of the world even by a vague anticipation of a reduction in the price of gold. Besides, there are several practical objections to the proposal. A reduction in the price of gold necessarily involves an upward revision in the value of money in terms of gold. If the Tripartite Agreement of September 1936 is to be maintained, such a revision has to come about by an international agreement and not by a unilateral action. In the U. S., it cannot come about by an executive decree, except to a very small extent, because the President has no authority to raise the value of the dollar above sixty per cent of its former parity, while already the dollar is at 59.06 per cent, and hence the sanction of the Congress will have to be sought for the purpose. In France, a reduction in the value of gold would mean a heavy loss, (which will have to be sustained either by the

1. With the one prominent exception of Professor Gustav Cassel. See his article in the *Daily Mail* of 9th June 1937.

Government or the Bank of France), because the gold reserve of the Bank of France has already been revalued on the basis of the new parity of the franc. It goes without saying that the Government is unable to bear the loss in its present financial circumstances, while if the Bank of France is to suffer it, it will positively lead to a restriction of credit. England, on the other hand, can take no action without the co-operation of America and France because the pound is already believed to be overvalued in terms of the dollar and no further increase in the degree of overvaluation can be tolerated by public opinion. Moreover, the losses incurred by the Exchange Equalisation Account on its sales of gold to the Bank of England are intended to be covered by the profits which are expected to accrue from a revaluation of the Bank's gold stock in the future. If the gold stock is revalued at a rate lower than the average rate at which the Account has purchased its gold, a part of the losses will remain outstanding and will make a permanent addition to the public debt. Besides, the British Empire is an important producer of gold, its share in the world gold production being 56.1 per cent in 1935, and hence the British authorities cannot be easily persuaded to consent to a proposal which would mean a definite loss to the Empire's gold producers and a reduction in the prospective value of a very important section of Britain's overseas investments.

The economic well-being of South Africa is dependent to a considerable extent on the prospects of the gold mining industry. Nearly half the population of South Africa is supported by the gold mines, although their output represents only a fifth of the total national income of the country.¹ The State is dependent on the Witwaterstrand gold mines for nearly one-half of its revenue.² It is easy to imagine what a serious damage would be inflicted on the industry and the public finances of South Africa by a reduction in the price of gold. Moreover, a reduction in price does not entirely remove the problem of absorbing gold; it simply reduces the cost of such absorption. It may to some extent discourage new production, but the new sources of supply that are opened up will continue to be exploited and hence the annual output will continue to be on a high level for many years to come.

1. Mr. G. Findlay Shirras in his article on "The Future of Gold" in the *Journal of the Indian Institute of Bankers* (July, 1937, p. 25) states that between two-thirds and three-fourths of the national income of South Africa are from gold mining. The statement does not appear to be correct. In the latest reliable estimate of national income made by the Department of Census and Statistics (quoted by Dr. Busschau: *The Theory of Gold Supply* p. 109), the proportion is stated to be one-fifth. The relative importance of the industry must have considerably increased in the last few years, but it is not yet established that it is the greatest single industry in South Africa.

2. Dr. Busschau, *Op. cit.*, p. 108-10 "It is undoubtedly the industry, contributing the largest tax payments and, relatively to its profits, it remains the most heavily taxed industry."

It has been suggested that like many other international commodities (like tea, rubber, tin, coffee etc.) gold also should be subjected to some international scheme of restriction of production. Indeed, if it was possible, this would be an ideal solution to the whole problem of maintaining the price of gold. Unfortunately, there are difficulties in the way of its execution.¹ Nearly 76 per cent of the world's output is produced in four countries, South Africa, Russia, Canada and the United States, while the remaining 24 per cent is scattered over more than twenty other countries. Due to this uneven nature of the distribution of production it will be difficult to evolve a plan that would be acceptable to the small as well as the big producers. It is, however, equally in the interest of all producers that the price of gold should be maintained and perhaps a realisation of this may help them to come to an understanding. It is an effort worth making, because if it is successful, it would considerably ease the present tension in the gold situation.

Unlike other restriction schemes which are already in force, the restriction of gold production is invested with a peculiar significance for the economic well-being of the world. If there is less tea or less coffee, perhaps the millions of poor people who are unable to consume it without a further fall in its price, are deprived of the pleasure; although a few of

1. Professor Cassel rejects this proposal on the ground of its impracticability.

them are better off due to the increased stability of employment which they enjoy as a result of the restriction scheme. A preponderant proportion of the annual output of gold is used either for monetary purposes or for hoarding, and an insignificant proportion goes into actual consumption. A continued increase in the supply of gold at a fixed price may lead the world into a dangerous state of inflation, while a reduction in its price will, as said above, inflict heavy losses on gold producers and will reduce the value of gold. So far from being prejudicial to the economic well-being of the world, a restriction of gold production will actually increase it. This is a matter which concerns not merely the gold producers, but also those who are responsible for the management of currency and credit and those millions of poor and rich people who have locked up their valuable savings in the form of gold. It follows, then, that we cannot leave it entirely to the good sense of the gold producers to solve this problem for us. A country like India which still holds gold worth hundreds of crores of rupees has as vital an interest in this matter as any other country in the world. Besides, there is this elementary fact that gold is primarily a medium of exchange for commodities and if the economic system of the world is run smoothly and the value of this particular type of exchange medium in terms of commodities is not to be radically changed, an increase in its supply has to bear a certain proportion to the

increase in the supply of commodities or the volume of exchanges. So long as the increase in the volume of exchanges, which depends on a revival of international trade and other factors, is still behind the increase in the production of gold, a restriction of production seems to be the only intelligible solution to the problem of maintaining its price. It is, therefore, imperatively necessary that a determined effort should be made by the leading nations to bring together all the important gold producers in order to explore the possibilities of an agreed restriction of production.

In the meanwhile some methods have to be devised by which the monetary systems of the world will be enabled to absorb the new gold without producing an inflationary effect on the credit situation. A suggestion has been made in the British financial press¹ that the various measures taken in the beginning of the depression to economise the use of gold should be reversed. The reserve requirements of central banks, for example, should be raised and the feasibility of re-introducing gold coins into circulation should also be considered. From the point of view of the education of the public in currency matters, however, the revival of gold currency will be a definitely retrograde step which will encourage hoarding. There has been a sudden *volte face* in the attitude of the economists towards hoarding. While, a few years ago, hoarding

1. *The Economist*, April 17, 1937.

was condemned by all as the villain of the piece and spending was considered to be the only thing that would save mankind from the evil of deflation, it is now thought inevitable that at least some members of the community or some countries should neither spend nor invest, but just hoard their incomes in the form of gold, if the forces of inflation which are already in operation in the world at large, are not to get out of hand. If India begins to re-absorb gold for hoarding purposes, it would be welcomed by many as a fortuitous solution to the problem of gold. It is, however, for India to decide how far it is in her interest to divert her valuable savings into unproductive channels in order that the South African producers of gold should continue to make a profit. If this country possesses a favourable balance apart from an import of gold, it should utilise it in reducing its external debt, or in making foreign investments or in increasing investments at home. With the gradual spread of banking habits, and the growing education of the public in the matter of investment, there is little chance of gold being hoarded in India on the same scale as in the early years of the present century. If, moreover, we invest the favourable balance at home, the increase in our imports which will inevitably follow, is sure to restrict the import of gold into the country. From a long run point of view it is in the interest of India that every effort should be made to direct her savings into productive channels instead of allowing them to be

hoarded in the form of barren metals.

Even from the international standpoint, it would not be a desirable development if the public gets accustomed again to an expensive form of currency. The re-introduction of gold coins into circulation must, therefore, be necessarily ruled out as an unwise measure. It is like increasing the circulating capital of a business even when there is no increase in its output or turnover. It is a waste of public resources. A revision of reserve requirements (or an increase in the metallic cover of the note issue) is also open to the same objection, but it is a more tolerable expedient, because its reversal will not be a very difficult task in case it is necessary in future. This, combined with the device of exchange equalisation accounts, will no doubt serve for a time to absorb the increase in gold production in the immediate future.

There can hardly be a difference of opinion on the point that the really permanent solution of the gold problem depends on two things: one is a more even distribution of gold and the other, a restoration of confidence in gold as the essential and indispensable basis of the world's mechanism of exchange. These two things are closely interdependent and without them no solution of the problem can have more than a temporary value. The world's monetary stock of gold is being increasingly concentrated into the vaults of a few creditor countries which have practically no use for it. Indeed, some part of it corresponds to foreign short

term funds and will be drawn out of the credit or countries when the owners of these funds repatriate them.¹ But that part of the gold acquired by the creditor countries which does not correspond to short term funds and which they do not require as the basis of internal credit will be of no use to them unless they are able to sell it *internationally* in exchange for goods or investments. It is as if a portion of their national income is thrown into a bottomless sink. They will, in the end, impoverish themselves if they do not realise that it is as much in their interest as in the interest of the gold-producing countries to see that the international demand for gold does not fall. Their gold is wealth only so long as this does not happen. Already the world has lost confidence in gold, because the whole weight of the world's gold production is at present being shouldered by two or three countries and the future value of gold depends on what the Governments in these countries choose to make it at their own discretion. It is difficult to have faith in gold even as a store of value unless the demand for it is more widely distributed. The only way in which this can come about is by a revival of international trade and a resumption of international

1. It has also been pointed out, in the case of England, that the gold reserves in London must be treated as the reserves of the whole of the sterling area as well as of England, because London has become the centre of the sterling area since 1931. (*The Economist*, 22.5.37).

lending. The creditor countries have necessarily to be more liberal in their trade and tariff policies and also to encourage the free flow of long term capital, if there is to be a demand for their gold. A bold policy of making long-term loans to countries which are in need of it and which can use them for productive purposes would be an ideal means for a redistribution of the world's gold supplies. But in a world which is blinded by economic nationalism these ideas are mere platitudes which have to be waived aside with a sigh.¹

In the opinion of some eminent economists the real key to the restoration of confidence in gold lies in a definitive stabilisation of world currencies on the basis of gold. It is sure to produce a demand for gold from different parts of the world and may also create an atmosphere in which international lending may be resumed and the dishoarding of gold may be checked. The various determinants of a satisfactory system of international exchange, namely, the removal of tariffs, the resumption of international lending, the amenability of the economic system to the control of central banks, the co-operation between central banks in the

1. Mr. D. Graham Hutton, speaking in 1930, said "The anarchy of the present system together with its recumbent apathy to any form of foreign lending will, if ignored, lead to a kind of apoplexy of the capitalist economy—congestion at the centre and anaemia at the extremities". (*The International Gold Problem*, p. 192.)

formation of their credit policies—are, really speaking, closely interdependent. It will involve us in a vicious circle to insist that some of them must take place before others. It is true that no country can remain on an international standard unless it is able to maintain its exchange rate, whenever there is a deficit on its balance of payments, without losing all its gold. And it will never be able to do it, if there are tariffs abroad to prevent it from increasing its exports, if it is unable to borrow abroad to cover its deficit, if the countries receiving its gold do not allow it to affect their internal credit situation, or if, simultaneously with the loss of gold, it is unable to reduce its own costs of production. But is the ultimate stabilisation of world currencies to wait till all these conditions are fulfilled? If so, the prospect of its coming about is as remote as that of a millennium. It should be possible to break the vicious circle, if all the major economic powers make a concerted attempt in that direction. But there is another serious difficulty. The heavy rearmament commitments of many countries will probably induce them to remain as free as possible from international restrictions. An immediate stabilisation, therefore, does not appear to be a practicable issue, however desirable it is for a genuine restoration of confidence in gold and as a really lasting support for its future value.

To sum up, the true hope for the maintenance of the value of gold in future depends on the ability

of the gold producers to restrict their production and on a revival of international trade. Meanwhile, all the devices which are at present being used to absorb the increasing supplies of gold must continue to function. A clear definition of their policy by the leading creditor nations on the crucial issue of stabilisation will greatly help to restore confidence in the future of gold. It is difficult to be dogmatic about the future trend of economic events, but since the international prices are already on the upgrade and the wheels of international trade have begun to move briskly, it may not be too optimistic to imagine that a better distribution of gold may come about and the value of gold may be automatically sustained even without any deliberate action. But this is no counsel for a lack of policy!

STATISTICAL APPENDIX

TABLE I

SUMMARISED BALANCES OF PAYMENTS OF THE UNITED STATES,
UNITED KINGDOM, FRANCE, GERMANY AND INDIA(In millions of old U. S. \$. The + sign indicates a net inward movement of payments
and the—sign a net outward movement)

Year	Merchandise	Total balance of goods & services	Gold	Total	Balance of capital items	Balance due to errors or omissions
(1) UNITED STATES OF AMERICA						
1929	+ 382	+ 400	— 120	+ 280	— 185	+ 95
1930	+ 386	+ 575	— 278	+ 297	— 678	— 381
1931	+ 17	+ 145	+ 176	+ 321	— 485	— 164
1932	+ 150	+ 101	— 11	+ 90	— 242	— 152
1933	+ 67	+ 174	+ 139	+ 313	— 344	— 31
1934	+ 173	+ 224	— 726	— 502	+ 215	— 287
1935	— 115	— 75	— 1,027	— 1,102	+ 906	— 196
(2) UNITED KINGDOM						
1929	— 1854.2	+ 501.2	+ 73.0	+ 574.2	...	...
1930	— 1878.2	+ 136.4	— 24.3	+ 112.1	...	...
1931	— 1850.3	— 471.6	+ 158.7	— 312.9	...	...
1932	— 1006.2	— 178.8	— 52.6	— 231.4	...	...
1933	— 871.5	—	— 649.5	— 649.5	...	...
1934	— 883.7	— 6.1	— 399.7	— 405.8	...	...
1935	— 759.3	+ 107.6	— 205.1	— 97.5	...	...

(3) FRANCE AND OVERSEAS TERRITORIES

1929	—	435.4	+	317.0	—	336.7	—	19.7	...
1930	—	506.2	+	202.3	—	459.8	—	257.5	...
1931	—	519.1	—	65.8	—	725.0	—	790.8	...
1932	—	395.3	—	193.0	—	724.4	—	917.4	...
1933	—	352.6	—	111.6	—	81.1	—	30.5	...
1934	—	264.0	—	44.6	—	57.6	—	102.2	...
1935	—	233.6	—	14.2	—	584.3	+	570.1	...

(4) GERMANY

1929	+	7.4	—	571.5	+	89.6	—	481.9	...
1930	+	391.6	—	126.0	—	3.1	—	129.1	...
1931	+	680.8	+	265.6	+	274.2	+	539.8	...
1932	+	251.1	+	60.0	+	43.4	+	103.4	...
1933	+	157.4	+	8.8	+	103.1	+	111.9	...
1934	—	60.0	—	131.0	+	72.0	—	59.0	...

(5) INDIA

1929-30	+	196.4	+	15.4	—	51.9	—	36.5	27.1
1930-31	+	135.6	—	45.1	—	46.6	—	91.7	46.6
1931-32	+	69.6	—	95.2	+	181.3	+	86.1	95.7
1932-33	—	14.3	—	146.5	+	171.3	+	24.8	13.5
1933-34	+	65.8	—	46.2	+	138.5	+	92.3	16.6
1934-35	+	25.0	—	78.2	+	116.7	+	38.5	4.2
1935-36	+	42.7	—	63.1	+	82.4	+	19.3	7.4

TABLE II

GOLD RESERVES OF SOME IMPORTANT
CENTRAL BANKS AND GOVERNMENTS
(in millions of U. S. dollars)

	1913	1929	1930	1931	1932	1933	1934*	1935*	1936*
United States	1290	3900	4225	4051	4044	4012	8238	10125	11258
England	164	709	718	587	582	928	1584	1648	2584
France	678	1633	2100	2699	3254	3022	5445	4395	2995
Germany	278	543	527	234	192	92	32	33	27
Belgium	48	163	190	354	360	380	590	611	632
Netherlands	60	180	171	356	415	371	573	438	490
Switzerland	33	114	137	452	476	386	624	454	655
Italy	267	273	278	295	307	373	518	270	...
Russia	786	147	249	328	367	416	744	839	...
India	123	128	128	161	161	162	275	275	275
South Africa	34	36	32	39	35	84	184	212	203
Canada	116	77	110	77	84	77	134	189	188
Japan	65	542	411	234	212	212	394	425	463

* Figures based on the new parity of the dollar : \$ 35 = 1 fine ounce of gold.
old parity : \$ 20.67 = 1 fine ounce of gold. The

TABLE III
MOVEMENTS OF GOLD
TO AND FROM INDIA ¹
(In lakhs of Rupees)

	Imports	Exports
Average of pre-war period	32.79	3.92
" of war period	10.60	2.99
" of post-war period (1919-20 to 1923-24)	21.57	9.03
" of five years (1924-25 to 1928-29)	33.68	18
" of five years (1929-30 to 1933-34)	6.54	37.26
1929-30	14.23	1
1930-31	13.24	49
1931-32	2.80	60.78
1932-33	1.32	66.84
1933-34	1.10	58.15
1934-35	.72	53.26
1935-36	.95	38.51
1936-37	1.61	29.45

¹ *Review of the Trade of India for 1935-36*, p. 169; *Monthly Statistics of Sea-borne Trade*, pp. 276-7.

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